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AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA Audit and Accounting Manual

***Nonauthoritative
Practice Aids***

As of July 1, 2003

AICPA Audit and Accounting Manual
As of July 1, 2003

AICPA

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA Audit and Accounting Manual

Nonauthoritative Practice Aids

Edited by:
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As of July 1, 2003

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ISBN 0-87051-465-2

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HOW TO USE THIS VOLUME

NEW CHANGES

This edition contains the following significant additions:

- Updated compilation and review guidance [AAM section 2000] reflecting the issuance of SSARS No. 9, *Omnibus Statement on Standards for Accounting and Review Services—2002* (AR sections 100 and 400)
- 2002/2003 Audit Risk Alerts [AAM section 8000]
- New engagement checklist, addressing independence compliance
- Extensive SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU section 316), guidance [section 3000]
- Updated State and Local Government section [AAM section 12,000] reflecting new pronouncements

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
 Audit Documentation
 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 AICPA *Technical Practice Aids* is referenced by the use of the following abbreviations: AUD (Auditing and Attestation Statements of Position).

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

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

AAM Section 1000

Introduction

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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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 <i>FASB Accounting Standards Current Text</i>
APB =	AICPA Accounting Principles Board Opinion
AR =	Reference to section number in <i>AICPA Professional Standards</i> (vol. 2)
ARB =	AICPA Accounting Research Bulletin
AT =	Reference to section number in <i>AICPA Professional Standards</i> (vol. 1)
AU =	Reference to section number in <i>AICPA Professional Standards</i> (vol. 1)
AUD =	Reference to section number in the <i>Auditing and Attestation Statements of Position in AICPA Technical Practice Aids</i> (vol. 2)
EITF =	Emerging Issues Task Force consensus
FASBI =	FASB Interpretation
PB =	AcSEC Practice Bulletin
QC =	Reference to section number in <i>AICPA 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 Lori West at (201) 938-3067.

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

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Cash- and Tax-Basis Financial Statements
Common Interest Realty Associations
Construction Contractors
Corporations
Defined Benefit Pension Plans
Defined Contribution Pension Plans
Development Stage Enterprises
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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] conforms to the *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report) and the 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 Audit Documentation section [AAM section 6000] provides the auditor with a general discussion of the purpose of audit documentation.
- 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 nine statements issued.

.08 SSARS No. 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 No. 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 No. 1 (AR section 100).

.10 SSARS No. 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 No. 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 No. 5 (Deleted by SSARS No. 7).

.13 SSARS No. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (AR section 600), provides an exemption from SSARS No. 1 for personal financial plans.

.14 SSARS No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992*.

.15 SSARS No. 8, *Amendment to Statements on Standards for Accounting and Review Services No. 1, Compilation and Review of Financial Statements* (AR section 100), provides communication and performance requirements for unaudited financial statements submitted to a client that are not expected to be used by a third party.

.16 SSARS No. 9, *Omnibus Statement on Standards for Accounting and Review Services—2002* (AR sections 100 and 400).

.17 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.

.18 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

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

[The next page is 2001.]

AAM Section 2000

Compilation and Review

This manual is a nonauthoritative practice aid and does not include extensive explanation or discussion of authoritative pronouncements. Users of this manual should refer directly to applicable authoritative pronouncements when appropriate.

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

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AAM Section 2100

Introduction

.01 Statements on Standards for Accounting and Review Services (SSARS) are issued by the American Institute of Certified Public Accountants (AICPA) Accounting and Review Services Committee (ARSC), the senior technical committee of the AICPA designated by its Council to issue pronouncements in connection with unaudited financial statements and other unaudited financial information of nonpublic entities. (A complete listing of SSARS and the full text can be found in *AICPA Professional Standards*, vol. 2.) 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) subsidiary, corporate joint venture, or other 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. For example, paragraph 1 of SSARS No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992*, 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).

Overview of SSARS and Interpretations

.03 ARSC has issued nine Statements on Standards for Accounting and Review Services. They are

- SSARS No. 1, *Compilation and Review of Financial Statements* (December 1978)

Replaced the former unaudited engagement standards contained in SAS No. 1. The statement provides guidance to CPAs concerning the standards and procedures applicable to engagements to compile or review financial statements. It does not establish standards or procedures for other services (e.g., tax return preparation or bookkeeping services).

- SSARS No. 2, *Reporting on Comparative Financial Statements* (October 1979)

Applies to reports on any comparative financial statements that include current period compiled or reviewed financial statements of an entity that is nonpublic as of the current period. Otherwise, SASs would apply.

- SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (December 1981)

Amends SSARS Nos. 1 and 2 to provide for an alternative form of standard compilation report on prescribed forms that call for departures from GAAP. It applies to any standard, preprinted form designed or adopted by the body to which it is submitted (e.g., a bank).

- SSARS No. 4, *Communications Between Predecessor and Successor Accountants* (December 1981)

Provides guidance to a successor who decides to communicate with a predecessor. The standard does not require communication and does require the predecessor to respond if authorized by the client.

- SSARS No. 5, *Reporting on Compiled Financial Statements* (July 1982; Deleted November 1992 by the issuance of SSARS No. 7)

All of the former SSARS No. 5 requirements are now included in SSARS Nos. 1, 2, and 3.

- SSARS No. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (September 1986)

Provides an optional exemption from SSARS No. 1 if the accountant establishes an understanding with the client, preferably in writing, that the financial statements:

- Will be used solely to assist the client and the client's advisors to develop the client's personal financial goals and objectives
 - Will not be used to obtain credit or for any other purpose
 - Indicate that nothing comes to the CPA's attention during the engagement that causes him to believe that the financial statements will be used to obtain credit or for other purposes
- SSARS No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992* (November 1992)
- Contains a number of technical amendments to various standards
- SSARS No. 8, *Amendment to Statement on Standards for Accounting and Review Services No. 1, Compilation and Review of Financial Statements* (October 2000)
- Amends SSARS No. 1 to create a management-use-only compilation (and make other changes)
- SSARS No. 9, *Omnibus Statement on Standards for Accounting and Review Services—2002* (November 2002)

Contains a number of technical amendments to SSARS No. 1 and SSARS No. 4

.04 SSARS No. 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 (owners) without undertaking to express any assurance on the financial 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 for them to be in conformity with generally accepted accounting principles or, if applicable, with another comprehensive basis of accounting (OCBOA).

.05 Paragraph 4 of SSARS No. 1 (AR section 100.04) defines a *financial statement* as.

A presentation of financial data, including accompanying notes, derived from the accounting records intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles. Financial forecasts, projections, and similar presentations, and financial presentations included in tax returns are not financial statements for purposes of this statement. SSARS No. 1 also gives the following specific examples of financial statements:

- Balance sheet
- Statement of income
- Statement of comprehensive income
- Statement of retained earnings
- Statement of cash flows

- Statement of changes in owners' equity
- Statement of assets and liabilities (with or without owners' equity accounts)
- Statement on revenues and expenses
- Statement of financial position
- Statement of activities
- Summary of operations
- Statement of operations by product lines
- Statement of cash receipts and cash disbursements

.06 Paragraphs 20 and 21 of SSARS No. 1, as amended by SSARS No. 8 (AR section 100.20–.21), include guidelines regarding an accountant's communications with the client when the compiled financial statements are not expected to be used by a third party. Paragraph 4 of SSARS No. 1 (AR section 100.04), as amended, defines *third parties* as all parties except for members of management who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements. This definition by exception indicates that all parties are third parties except for certain members of management who are knowledgeable enough about the business to put the information in the proper context.

.07 SSARS No. 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 No. 1 (AR section 100).

Practice Tip

If prior-period financial statements are not presented in columnar form, they do not meet the SSARS No. 2 definition of comparative financial statements and, therefore, are not subject to the reporting requirements of SSARS No. 2. In addition, the requirements of SSARS No. 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.

.08 SSARS No. 3 (AR section 300) amends SSARS Nos. 1 and 2 (AR sections 100 and 200) to provide an alternative form of compilation report when a prescribed form calls for a departure from generally accepted accounting principles (GAAP). Paragraph 2 of SSARS No. 3 (AR section 300.02), defines a prescribed form as any standard, preprinted form designed or adopted by the body to which it is intended to be submitted (e.g., banks and governmental bodies).

.09 SSARS No. 3 (AR section 300) does not prohibit the accountant from issuing a SSARS No. 1 (AR section 100) compilation report that identifies GAAP departures in accordance with paragraphs 41 through 43 of SSARS No. 1 (AR section 100.41–.43). A SSARS No. 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 only for a compilation service and not for a review service.

.10 SSARS No. 4 (AR section 400), as amended by SSARS Nos. 7 and 9, provides guidance on required, as well as, optional communications between predecessor and successor accountants. SSARS No. 7 amended SSARS No. 4 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. SSARS No. 9 amends SSARS No. 4 by providing

guidance on communications between accountants when the successor accountant decides to communicate with the predecessor regarding acceptance of an engagement. The amendment defines predecessor and successor accountants, provides guidance regarding acceptance of an engagement, suggests inquiries the successor accountant may decide to ask the predecessor accountant, and includes an example successor accountant acknowledgement letter, which the predecessor may want to use in connection with granting access to working papers.

.11 Under SSARS No. 6 (AR section 600.02), an accountant may submit a written personal financial plan containing unaudited personal financial statements to a client without issuing a report under SSARS No. 1 (AR section 100), as amended, when all of the following conditions exist—

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

.12 Examples of implementation of a personal financial plan by a client's advisors 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.

.13 An accountant following the exemption under SSARS No. 6 (AR section 600) should issue a written report stating that the unaudited financial statements—

- Are designed solely to help develop the financial plan.
- 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.
- Have not been audited, reviewed, or compiled.

.14 SSARS No. 7, which is an omnibus statement, among other things—

- Clarified the applicability of SSARS No. 1 (AR section 100) by indicating that, in certain circumstances, an accountant may perform a review of a public company under the provisions of SSARS.
- Eliminated the prohibition against merely typing or reproducing financial statements without modification and defined the term *submission of financial statements*.¹
- Made explicit that the accountant is not required to communicate to a client errors that are not material and fraud or illegal acts that are clearly inconsequential.
- Modified the SSARS review report to differentiate it from the review report presented in SAS No. 100 (AU section 722), *Interim Financial Information*, as well as the review and compilation report to clarify that the standards referred to in the reports are Statements on Standards for Accounting and Review Services.
- Required a client representation letter when performing a review engagement under SSARS.

¹ The term *submission of financial statements* has since been redefined by SSARS No. 8.

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

.15 SSARS No. 8 amends SSARS No. 1 (AR section 100) to provide communication and performance requirements for unaudited financial statements submitted to a client that are not expected to be used by a third party. *Submission of financial statements* is defined as presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software. The following two actions are necessary in order to *submit* financial statements—(1) prepare financial statements, either manually or through the use of computer software, and (2) present the financial statements to a client or third party. [SSARS No. 1 sets forth the performance and communication requirements when an accountant submits unaudited financial statements of a nonpublic entity to his or her client or third parties.]

.16 SSARS No. 8 amends SSARS No. 1 (AR section 100) to create a provision for management-use-only financial statements (when an accountant submits financial statements to a client that are not reasonably expected to be used by a third party) indicating that he or she should document an understanding with the client through the use of an engagement letter or follow the requirements in SSARS No. 1 for issuing a compilation report.

.17 SSARS No. 9 is an omnibus statement. Following is a summary of the amendments included in SSARS No. 9—

- The auditing literature permits an accountant who may be associated with financial statements of a public company, but has not audited or reviewed such statements to state that he or she has not audited the unaudited information and includes illustrative report wording. This guidance is also appropriate for compilation and review engagements; however, SSARSs currently does not include illustrative wording. This amendment revises SSARS No. 1, *Compilation and Review of Financial Statements* (AR section 100.03), to include wording that may be appropriate under the circumstances.
- SSARS No. 9 includes two footnotes to SSARS No. 1 (AR section 100.14 and 100.36), stating (1) the statement of retained earnings is not a required statement and, if not presented as a separate statement, reference in the compilation and review report is not needed and (2) if the statement of comprehensive income is presented, reference should be made in the appropriate paragraphs of the report.
- SSARSs did not specifically require a signature of the accounting firm or the accountant on a review or compilation report. This amendment revises SSARS No. 1 (AR section 100.11 and 100.33) to require a signature.
- SSARS No. 9 requires the accountant to obtain specific representations from management when performing a review engagement, provides guidance on the dating of the letter, and provides guidance regarding obtaining representations from current management when they were not present during all periods covered by the accountant's report.
- SSARS No. 9 explicitly permits the accountant to issue a separate report on supplementary information in a compilation engagement, consistent with guidance on supplemental information in a review report.
- SSARS No. 9 clarifies that although an effective quality control system is conducive to compliance with SSARSs, deficiencies in or noncompliance with a firm's quality control system do not, in and of themselves, indicate that an engagement was not performed in accordance with the applicable professional standards.
- SSARS No. 9 defines predecessor and successor accountants, provides guidance regarding acceptance of an engagement, suggests inquiries the successor accountant may decide to ask the predecessor accountant, and includes an illustrative successor-accountant acknowledgment letter that the predecessor may want to use in connection with granting access to the working papers.

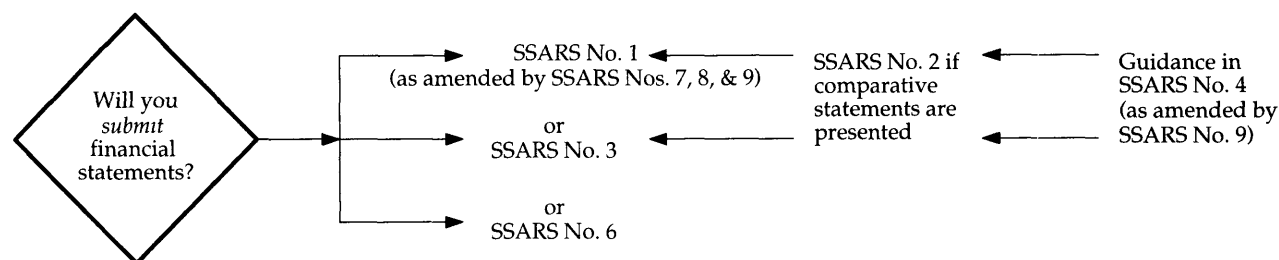
.18 Every standard does not apply to every engagement. SSARS No. 1 (AR section 100), as amended by SSARS Nos. 7, 8, and 9, generally applies to any engagement in which the accountant submits financial statements to a client or third parties (compilation or review engagement). SSARS No. 2 (AR section 200) applies to any engagement to report on comparative financial statements.

.19 SSARS No. 3 (AR section 300) and SSARS No. 6 (AR section 600) are considered optional exemptions from SSARS No. 1 (AR section 100). (SSARS No. 1 applies unless the conditions in SSARS No. 3 or SSARS No. 6 are met.) SSARS No. 3 is considered a partial exemption and applies if the engagement is to compile financial statements contained in certain prescribed forms. The performance standards in SSARS No. 1 apply, but the reporting standards are replaced by the special reporting requirements of SSARS No. 3. SSARS No. 6 is considered a complete exemption from SSARS No. 1. If the SSARS No. 6 conditions are met, SSARS No. 1 does not apply.

.20 SSARS No. 4 (AR section 400) contains recommended communication guidance for any compilation or review engagement where a change of accountants has occurred.

.21 Exhibit 2100.1 illustrates the interactions between the standards:

Exhibit 2100.1—Interaction of SSARS



.22 Illustrative reports to be issued under the provisions of SSARS Nos. 1 through 9 can be found in AAM sections 2610, 2620, and 2710.

.23 In addition to SSARS Nos. 1 through 9, interpretations issued by the staff of ARSC provide timely guidance on applying SSARS. An interpretation is not as authoritative as a SSARS, but accountants may have to justify departure from an interpretation's guidance if the quality of their work is questioned. The following interpretations have been issued by the staff.

Interpretations of SSARS No. 1

.24 No. 1—*Omission of Disclosures in Reviewed Financial Statements* (AR section 9100.01–.02, December 1979) This interpretation precludes the accountant from accepting an engagement to review financial statements that omit substantially all the disclosures required by GAAP. This interpretation gives guidance on the reporting implications if an accountant who has undertaken a review of financial statements subsequently finds that the client declines to include substantially all required disclosures.

.25 No. 2—*Financial Statements Included in SEC Filings* (AR section 9100.03–.05, December 1979) This interpretation basically concludes that a compilation or review report should not be filed with the SEC.

.26 No. 3—*Reporting on the Highest Level of Service* (AR section 9100.06–.12, December 1979; revised October 2000) This interpretation requires that if an accountant provides more than one level of service on the same financial statements, the financial statements should be accompanied by the accountant's report that is

appropriate for the highest level of service provided. This interpretation does not preclude the accountant from using procedures that go beyond those required for the level of assurance expressed. Nor does this interpretation require that the accountant “step up” the level of his or her report if the accountant uses procedures that go beyond those required for the level of assurance expressed.

.27 No. 4—*Discovery of Information After the Date of the Accountant’s Report* (AR section 9100.13–.15, November 1980) The interpretation emphasizes the need for professional judgment in determining an appropriate course of action when information becomes available after the date of the accountant’s report and that information causes the accountant to believe that the compiled or reviewed financial statements may be incorrect, incomplete, or otherwise unsatisfactory. This interpretation instructs the accountant to consider the reliability of the information and the existence of persons known to be relying on or likely to rely on the financial statements when making a decision about an appropriate course of action.

.28 No. 5—*Planning and Supervision* (AR section 9100.16–.17, August 1981) The interpretation clarifies that the audit guidance in “Planning and Supervision,” does not apply to compilation or review engagements. However, this interpretation suggests that the accountant may wish to consider SAS No. 22, *Planning and Supervision* (AU section 311), and other references when planning and supervising a compilation or review engagement.

.29 No. 6—*Withdrawal From Compilation or Review Engagement* (AR section 9100.18–.22, August 1981) The interpretation identifies circumstances in which it is appropriate for an accountant to withdraw from an engagement. Circumstances suggested include those in which the nature, extent, and probable effect of GAAP departures or departures from an OCBOA might cause the accountant to question whether the departures are a result of the preparer’s intention to mislead those who might reasonably be expected to use the financial statements. The accountant would also withdraw from a compilation or review engagement if the financial statements are not revised after the accountant requests that revisions be made, and the client refuses to accept the modified standard report that the accountant believes is appropriate.

.30 No. 7—*Reporting When There Are Significant Departures From Generally Accepted Accounting Principles* (AR section 9100.23–.26, August 1981) The interpretation indicates that a statement in a compilation or review report that the financial statements are not in conformity with GAAP or an “other comprehensive basis of accounting” would be tantamount to expressing an adverse opinion on the financial statements taken as a whole; therefore, an accountant is precluded from making such a statement. Such an opinion can be expressed only in the context of an audit engagement. This interpretation does not preclude the accountant from emphasizing the limitation of the financial statements in a separate paragraph of the report. This separate paragraph is not, however, a substitute for disclosure of the specific GAAP or OCBOA departures or the effects of the departures.

.31 No. 8—*Reports on Specified Elements, Accounts, or Items of a Financial Statement* (AR section 9100.27–.28, November 1981; revised January 2001) The interpretation clarifies that the SSARS No. 1 reporting requirements for a review do not apply to presentations of specified elements, accounts, or items of financial statements because these presentations do not meet the definition of a financial statement. This interpretation refers the accountant to SSAE No. 10, *Attestation Standards: Revision and Recodification*, chapter 2, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1, AT section 201) for guidance on reporting on the results of applying agreed-upon procedures to specified elements, accounts, or items of a financial statement. SSAE No. 10, chapter 1, *Attest Engagements* (AT section 101) provides guidance on reporting on such presentations when the accountant is engaged to express moderate assurance in a review report.

.32 No. 9—*Reporting When Management Has Elected to Omit Substantially All Disclosures* (AR section 9100.29–.30, May 1982) The interpretation allows the accountant to modify the language in the sample report in paragraph 21 of SSARS No. 1 from “Management has elected to omit substantially all disclosures.” However, this interpretation stresses that the language used should clearly indicate that the omission of

substantially all disclosures is the entity's decision, not the accountant's. The interpretation encourages the use of the language in the sample report in paragraph 21 of SSARS No. 1.

.33 No. 10—*Reporting on Tax Returns* (AR section 9100.31–.32, November 1982) SSARSs do not apply to tax returns. The interpretation exempts the accountant from compiling the financial information contained in a tax return, although the accountant may accept an engagement to compile or review such a presentation.

.34 No. 11—*Reporting on Uncertainties* (AR section 9100.33–.40, December 1982) The interpretation directs the accountant to paragraphs 10 and 11 of SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341.10–.11), for guidance in evaluating the disclosure of uncertainties. This interpretation does not require the accountant to modify his or her report if uncertainties are appropriately disclosed in the financial statements; nor does the interpretation require modification of a compilation report on financial statements that omit substantially all disclosures required by GAAP, provided the report clearly indicates the omission and says that the client's decision to omit the disclosures was not, to the accountant's knowledge, undertaken with the intention of misleading users of the statements. The interpretation suggests, but does not require, language that may be used if an accountant wishes to draw attention to an uncertainty in an emphasis paragraph of a compilation or review report.

.35 No. 12—*Reporting on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles* (AR section 9100.41–.45, December 1982; revised November 1992 and October 2000) The interpretation illustrates how the standard compilation and review reports should be modified if financial statements are prepared on another comprehensive basis of accounting. Footnotes to the financial statements should state the basis of presentation and describe how that basis differs from GAAP. If footnotes present this information, the standard compilation and review reports should be appropriately modified to identify the financial statement title (e.g., Balance Sheet—Income Tax Basis). When an accountant compiles OCBOA financial statements that omit substantially all disclosures, either a footnote or a note to those statements should disclose the basis of accounting. If that disclosure is not made, the following sentence should be added to the first paragraph of the accountant's report:

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.

.36 No. 13—*Additional Procedures* (AR section 9100.46–.49, March 1983; revised October 2000) The interpretation permits the accountant to perform additional procedures in a compilation or review engagement without requiring the accountant to change the engagement level.

.37 No. 14—*Reporting on Financial Statements When the Scope of the Accountant's Procedures Has Been Restricted* (AR section 9100.50–.53, Withdrawn—April 1990)

.38 No. 15—*Differentiating a Financial Statement Presentation From a Trial Balance* (AR section 9100.54–.57, September 1990; revised October 2000) The interpretation identifies the attributes of a financial statement and those of a trial balance. It assists an accountant in determining whether a financial statement presentation is a financial statement, requiring compliance with the provisions of SSARS No. 1, or a trial balance, which does not require compliance with the provisions of SSARS No. 1.

.39 No. 16—*Determining if the Accountant Has "Submitted" Financial Statements Even When Not Engaged to Compile or Review Financial Statements* (AR section 9100.58–.60, Withdrawn by the issuance of SSARS No. 7—November 1992)

.40 No. 17—*Submitting Draft Financial Statements* (AR section 9100.61–.62, September 1990; revised October 2000) The interpretation prohibits an accountant from submitting draft financial statements without intending to submit those financial statements in final form accompanied by an appropriate compilation or review report. This interpretation requires that draft financial statements be so marked and suggests that an

accountant document the reasons why he or she intended to submit, but never submitted final financial statements, should that situation occur.

.41 No. 18—*Special-Purpose Financial Presentations to Comply With Contractual Agreements or Regulatory Provisions* (AR section 9100.63–.72, September 1990) The interpretation permits an accountant, if asked to report on special-purpose financial statements prepared to comply with a contractual agreement or regulatory provision that specifies a special basis of presentation, to issue a compilation or review report on those financial statements in accordance with SSARS No. 1. The interpretation describes how to report on presentations based on contractual agreements or regulatory provisions that require a financial presentation that (1) does not constitute a complete presentation of the entity’s assets, liabilities, revenues, or expenses but is otherwise prepared in conformity with GAAP or OCBOA or (2) uses a prescribed basis of accounting that does not result in a presentation in conformity with GAAP or OCBOA.

.42 No. 19—*Reporting When Financial Statements Contain a Departure From Promulgated Accounting Principles That Prevents the Financial Statements From Being Misleading* (AR section 9100.73–.75, February 1991; revised October 2000) The interpretation addresses Ethics Rule 203, *Accounting Principles* of AICPA Code of Professional Conduct (AICPA *Professional Standards*, vol. 2, ET section 203.01), which prohibits a member from expressing an opinion that financial statements are presented in conformity with GAAP if the member is aware that the statements contain a GAAP departure. If the statements contain a GAAP departure, and the member can demonstrate that due to unusual circumstances compliance with GAAP would render the financial statements misleading, the member can comply with Rule 203 by describing in the report the departure; its approximate effects, if practicable; and the reasons why compliance with GAAP would result in misleading statements. The interpretation indicates that if the circumstances contemplated by Rule 203 exist in a review engagement, the accountant’s review opinion should be unmodified, but the accountant’s review report should be modified to contain a separate paragraph, including the information required by Rule 203. The interpretation clarifies that Rule 203 does not apply to compilation engagements. If the circumstances contemplated by Rule 203 exist in a compilation engagement, an accountant should follow the guidance in paragraphs 39 through 41 of SSARS No. 1 for reporting on a compilation engagement with a GAAP departure.

.43 No. 20—*Applicability of SSARS to Litigation Services* (AR section 9100.76–.78, May 1991; revised October 2000) SSARSs do not apply to financial statements submitted in litigation services that involve pending or potential proceedings before a court, regulatory body, or governmental authority (or the agent of any of these) such as a grand jury or an arbitrator (mediator) when the

- Accountant is an expert witness or a “trier of fact” (or an agent for one).
- Accountant’s work is subject to detailed analysis and challenge by each party to the dispute.
- Accountant is engaged by the attorney and protected by the attorney’s work product privilege.

.44 *Applicability of SSARS No. 1 When Performing Controllorship or Other Management Services* (AR sections 9100.80–.84, July 2002) The interpretation clarifies that if the accountant is in the practice of public accounting as defined by the AICPA’s Code of Conduct [ET section 92.23] and is not a stockholder, partner, director, officer, or employee of the entity, the accountant is required to follow the performance and communication requirements of SSARS No. 1, including any requirement to disclose a lack of independence. The interpretation further states that if the accountant is in the practice of public accounting and is also a stockholder, partner, director, officer, or employee of the entity, the accountant may either (1) comply with the requirements of SSARS No. 1, or (2) communicate, preferably in writing, the accountant’s relationship to the entity (for example, stockholder, partner, director, officer, or employee). In addition, if an accountant is not in the practice of public accounting, the issuance of a report under SSARS would be inappropriate.

Interpretation of SSARS No. 2

.45 No. 1—*Reporting on Financial Statements That Previously Did Not Omit Substantially All Disclosures* (AR section 9200.01–.04, November 1980) If the financial statements are compiled (disclosures omitted) from

financial statements that previously did not omit disclosures, the accountant's reference to the previous reports should include a description or quotation of any report modification or emphasis matter.

Interpretation of SSARS No. 3

.46 No. 1—*Omission of Disclosures in Financial Statements Included in Certain Prescribed Forms* (AR section 9300.01–.03, May 1982) This interpretation permits an accountant who has reviewed financial statements of a nonpublic entity to issue a compilation report on financial statements for the same period in a prescribed form that calls for a departure from GAAP.

Interpretation of SSARS No. 4

.47 No. 1—*Reports on the Application of Accounting Principles* (AR section 9400.01–.05, August 1987) An accountant who has been asked to provide written or oral advice on the application of accounting principles to a client whose financial statements are compiled or reviewed by another accountant is obligated to follow SAS No. 50, *Reports on the Application of Accounting Principles* (AU section 625).

Interpretation of SSARS No. 6

.48 No. 1—*Submitting a Personal Financial Plan to Client's Advisers* (AR section 9600.01–.03, May 1991) The interpretation allows the accountant to submit a written personal financial plan, to be implemented by the client or his or her advisers, without complying with SSARS No. 1. Examples of implementation include an:

- Insurance broker to identify specific products.
- Investment adviser to provide investment portfolio recommendations.
- Attorney to draft a will or trust agreement.

Determining Applicability of SSARS No. 1

.49 SSARS No. 1 (AR section 100) is applicable whenever an accountant submits unaudited financial statements of a nonpublic entity to a client or third parties. SSARS No. 8 (AR section 100) modified the definition of "submission." *Submission of financial statements* is now defined as—

presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software.

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

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

.51 Absent either of these actions, the financial statements have not been submitted, and SSARS No. 1 is not applicable.

.52 The term "prepared" is not defined in SSARS. Rather, professional judgment must be used to determine if financial statements will be prepared. In making this judgment, the accountant should consider the difference between mere bookkeeping services (e.g., making adjustments, corrections, accruals, etc.) and preparation of financial statements. In order to prepare financial statements the accountant must use his or her knowledge, education, and experience to create financial statements that would not have existed otherwise. In other words, if the financial statements prepared by the client's bookkeeper require only that the accountant "tweak a couple of things," then financial statements probably haven't been prepared. On the other hand, if the client gives the accountant an unadjusted trial balance and the accountant makes all of

the adjustments necessary to convert the information into financial statements, then financial statements probably have been prepared.

Practice Tip

There is no definitive line to cross that would indicate submitting financial statements. Therefore, a firm policy should be established to evaluate how certain accounting services are classified within the firm.

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

.54 The issue of “submission” should be addressed early in engagement planning. This issue, along with the needs of the client and other financial statements users, is essential to determining the type of engagement to perform.

[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 Rules 201, *General Standards*, and 202, *Compliance With Standards*, respectively, of the AICPA's *Code of Professional Conduct* (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:

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

.02 Rule 202 requires that an AICPA member who performs audit, review, compilation, management consulting, tax or other professional services comply with standards promulgated by bodies designated by Council.

Client and Engagement Selection

.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.

.04 Although professional standards do not require consideration of the following issues, you might consider them in determining whether or not to accept a client:

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

.05 Some of the following tips may be helpful when evaluating a potential client (although none of these procedures is required by professional standards):

- *Gain access to available financial information.* Review the prior year's financials, with emphasis on leverage for debt. Look at the client's assets and sources of income, as well as the current condition of accounting records.
- *Review S&P, Moodys, or other publications.* Many localities provide a local or regional "S&P" in conjunction with the *Daily Journal of Commerce* or similar business publication. There is a plethora of available information on the Web. In addition, many firms offer database searches of financial, legal, and operational information, as well as personal information about key executives. Check the court dockets (including the U.S. Bankruptcy and Tax Court dockets) in the area where the client is domiciled.

- *Meet with financial persons of the company.* Ask for a brief overview of their internal practices and procedures, the business plan, bylaws, staff turnover, and so on. Representatives from other departments may provide information as well.
- *Discuss the prospective client with former accountants* (after the client provides written authorization).

.06 It is often useful to complete a “Client Acceptance and Continuance Form” to assist in determining whether or not to accept a client. An illustrative client acceptance form can be found in AAM section 2200.58.

Client Needs

.07 Generally, the cost of a review will be more than a compilation, and the cost of a compilation with full disclosure will be more than a compilation that omits substantially all disclosures. These cost considerations should be carefully explained and evaluated with the client. In addition, special consideration should be given to the issues of independence and the demands of bankers and other creditors.

.08 Several issues must be considered in determining the best type of engagement for a particular client, including:

- *Needs of third parties.* Does a third party (for example, a bank) need financial statements on a regular basis?
- *Cost-benefit considerations.* Which engagement can be performed at a reasonable cost to the client?
- *Risk management considerations.* Some practitioners may perceive the “management-use-only” compilation as potentially more risky than a “traditional”¹ compilation. Others, however, see the specific representations and restrictions agreed to in the engagement letters for management-use-only engagements as additional protections that are not present in the report that accompanies a traditional compilation engagement.

.09 If the client does not need audited financial statements, the accountant can choose from these four types of engagements:

- A review (if the accountant is independent and the client needs a moderate level of assurance on the financial statements)
- A traditional compilation² (the minimum level of service required if third parties will use the financial statements)
- A management-use-only compilation³ (available if third parties will not use the financial statements)
- Bookkeeping services (available if the procedures do not include the submission of financial statements)

Traditional Versus Management-Use-Only Compilation

.10 SSARS No. 1 (AR section 100.04) defines a *compilation* as follows:

Presenting in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the statements.

.11 This definition does not require the accountant to test, verify, or corroborate information supplied by management, but, simply, to place the information into the form of financial statements.

¹ See paragraph .12 for more information about types of compilations.

² See paragraph .12 for more information about types of compilations.

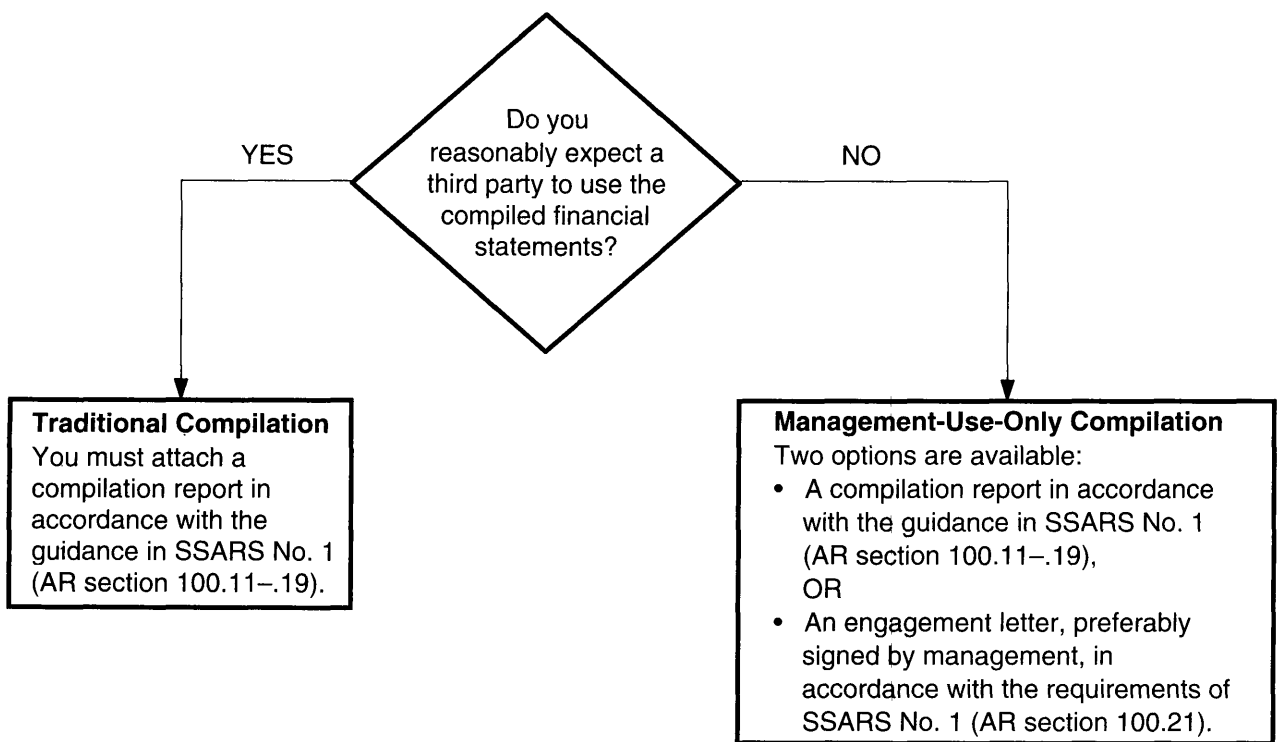
³ See paragraph .12 for more information about types of compilations.

.12 SSARS No. 1 (AR section 100), as amended, now provides for two types of compilations:

- A compilation with a report is required when the accountant has been engaged to compile and report on the financial statements or when the accountant reasonably expects that the financial statements may be used by a third party. This type of engagement might be referred to as a *traditional compilation*.
- A compilation without a report is available when the accountant does not reasonably expect the financial statements to be used by a third party. This type of engagement might be referred to as a *management-use-only compilation*.

.13 In either case, the engagement is a compilation requiring that the accountant comply with the performance requirements of SSARS No. 1 (AR section 100). The difference between the two options lies in the form of communication used in the engagement. See Exhibit 2200.1.

Exhibit 2200.1—Communications Options in



.14 Though not required by professional standards, you might consider making the decision about the best type of engagement for the client early in engagement planning and base that decision on a combination of (1) the needs of the client and other users, (2) knowledge of the client, and (3) the nature of the procedures that will be performed.

.15 If the client does not need compiled financial statements (taking into account the needs of the client and other users), the accountant may, instead, choose to perform only bookkeeping services. Other than the broad general ethical guidance available in ET section 201 of AICPA *Code of Professional Conduct*, there are no authoritative standards for bookkeeping services. Thus, it is wise to at least establish a written understanding with the client concerning bookkeeping services. This understanding should include:

- A description of the nature and limitations of the services.
- A statement that the engagement cannot be relied upon to detect errors, fraud, or illegal acts.

Practice Tip

Bookkeeping services fall under the guidance in Statements on Standards for Consulting Services (SSCSs). SSCS No. 1, *Consulting Services: Definitions* (CS section 100), states that you should have an “understanding with the client” for any consulting engagement that you undertake. This oral or written understanding should be reached with the client about the responsibilities of the parties and the nature, scope, and limitations of the engagement to be performed. If circumstances require a significant change during the engagement, the understanding should be modified.

.16 Although not an authoritative requirement in a traditional compilation engagement, a written engagement letter for a bookkeeping services engagement could be important because there are no specific standards to follow for these types of engagements. Other professional engagements, such as audits, reviews, and compilations, include the added benefit of authoritative standards that define the engagement objectives, limitations, communication, and so on. An illustrative engagement letter for a bookkeeping service engagement can be found in AAM section 2200.62.

Independence Issues

.17 If an accountant is not independent, he or she can only issue a compilation report (with report modification). If the client needs reviewed or audited financial statements, the nonindependent CPA should refer the client to another CPA. The primary rules governing independence are found in the “Independence” section of the AICPA *Code of Professional Conduct* (ET section 101). The independence standards are contained in Rule 101, *Independence* (ET section 101.01) along with the associated interpretations and ethics rulings. Rule 101 states:

A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.

.18 Independence is the foundation of the attest function. Third party users rely on the CPA’s opinion in a review engagement because they believe the conclusion is impartial and unbiased.

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

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

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

Understanding the Engagement

.22 Paragraph 5 of SSARS No. 1 (AR section 100.05) states that the accountant should establish an understanding with the entity, preferably in writing, regarding the services to be performed. If the engagement is to compile financial statements not expected to be used by a third party, a written communication is required. (See AR section 100.20–.21.)

Establishing an Understanding With the Client

.23 As noted in the previous paragraph, SSARS No. 1 (AR section 100.05) requires the CPA to obtain an understanding with the client. This understanding should include:

- a. A description of the nature and limitations of the services.
- b. A description of the report the accountant expects to render.
- c. A statement that the engagement cannot be relied upon to detect errors, fraud, or illegal acts.
- d. A statement that the accountant will inform the appropriate level of management of any material errors that come to his attention and any fraud or illegal acts that come to his attention, unless they are clearly inconsequential.

.24 If the financial statements are not expected to be used by third parties (management-use-only compilation), the documentation of understanding should include the following descriptions or statements, according to paragraph 21 of SSARS No. 1, as amended by SSARS No. 8 (AR section 100.21):

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

.25 According to paragraph 21 of SSARS No. 1, as amended by SSARS No. 8 (AR section 100.21), the documentation of understanding should also address the following additional matters, if applicable:

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

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

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

What to Include in an Engagement Letter

.27 The following items of information to include in an engagement letter are suggestions only; these items do not represent authoritative requirements:

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

Overcoming Client Resistance to an Engagement Letter

.28 If you should encounter a situation in which your client exhibits reluctance about or resentment to an engagement letter, presenting the engagement letter face-to-face usually is sufficient to overcome any resistance on the part of the client.

.29 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.

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

Engagement Letters for Monthly, Quarterly, or Comparative Statements

.31 One engagement letter can be drafted to cover financial statements issued for a period of time, such as a year, or for comparative financial statements issued for multiple periods. It is also possible to use one engagement letter for all services to be performed (compilation, review, consulting, bookkeeping, tax services, etc.). However, care should be taken when addressing multiple levels of service (e.g., compilation and review) in one engagement letter, as this can be confusing to the client.

Minimizing Liability to Third Parties

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

We understand that you are negotiating with Last National Bank for a loan of \$100,000 and that the purpose of our report on your financial statements is to enable you to present the compiled [reviewed] financial statements to Last National 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.

.33 The use of language such as this in engagement letters varies in practice. Some CPAs feel that the language may offend clients and/or actually increase the likelihood of litigation from the identified third party. Before adding such language, the accountant should consult with legal counsel.

.34 Illustrative engagement letters for compilation engagements are presented in AAM section 2200.59–.60.

Practice Tip

Care should be exercised in adding additional services to the engagement letter. Although it is common to address additional services such as bookkeeping, tax, payroll, and consulting in this engagement letter, it is not advisable to include both the management-use compilation and traditional (unrestricted) compilation engagements in the same engagement letter. Should the client need compiled financial statements for third party use, it is recommended that a separate engagement letter be issued in order to reduce the risk of misunderstanding and confusion about the two types of engagements.

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

Change in Engagement Level of Service

.35 Occasionally, during the course of an engagement, the client may request that the CPA change the nature of the engagement. The request may be for a:

- Step-up—for example, from a compilation to a review
- Change in service—for example, from a management-use-only compilation to a traditional compilation or from a traditional compilation to a review
- Step-down—for example, from an audit to a review or compilation

- Step-down—for example, from a review to a compilation
- Change in service—from a compilation with disclosures to a compilation without disclosures
- Change in service—for example, from a traditional compilation to a management-use-only compilation, or from a management-use-only compilation to bookkeeping services

Step-Ups

.36 SSARS No. 1 does not specifically address step-ups. Generally, step-ups pose no issues of great concern. The CPA must:

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

.37 If the client needs financial statements for third-party use, the accountant may compile, review, or audit the financial statements for that client and comply with the reporting requirements in SSARS No. 1 (AR section 100). The accountant may do this even if he or she has previously compiled the financial statements for management's use only.

Practice Tip

You may want to include language in the engagement letter alerting the client to the fact that if he or she needs financial statements for third-party use (compiled, reviewed, or audited), you can provide that service separately.

Step-Downs and Changes in Service

Step-Down From Audit to Review or Compilation

.38 SSARS No. 1 lists three reasons that might cause a client to request a change from an audit engagement to another type of engagement after an audit has begun:

- A change in circumstances affecting the entity's requirement for an audit
 - For example, a bank may no longer require an audit because a line-of-credit is reduced to a level that does not require audited financial statements.
 - Generally, a step-down in this case is acceptable.
- A misunderstanding as to the nature of an audit, review, or compilation services originally available
 - Generally, a step-down in this case is acceptable.
 - The CPA should, however, explain all of the options available to the client.
- A restriction on the scope of the audit, whether imposed by the client or caused by circumstances
 - The implications of a scope restriction need to be considered carefully.
 - SSARS No. 1 describes two circumstances that would preclude a step-down:
 - 1) The accountant has been prohibited from corresponding with the entity's legal counsel.
 - 2) The management or owner has refused to sign a client representation letter.

Step-Down From Review to Compilation

.39 SSARS No. 1 lists three reasons that might cause a client to request a change after a review has begun:

- A change in circumstances affecting the entity's requirement for a review
 - For example, a bank may no longer require a review because a line-of-credit is reduced to a level that does not require audited financial statements.
 - Generally, a step-down in this case is acceptable.
- A misunderstanding as to the nature of an audit, review, or compilation services originally available
 - Generally, a step-down in this case is acceptable.
 - The CPA should, however, explain all of the options available to the client.
- A restriction on the scope of the inquiries or analytical procedures, whether imposed by the client or caused by circumstances.
 - The implications of a scope restriction need to be considered carefully.
 - The management's or owner's refusal to sign a client representation letter would preclude a step-down.

Change in Service From Full Disclosure to Omission of Substantially All Disclosures

.40 The accountant can agree to a request to change in service from a compilation with full disclosure financial statements to a compilation with financial statements that omit substantially all disclosures only if, to the best of his knowledge, the omission of disclosures is not intended to mislead those who might reasonably be expected to use the statements.

Change in Service From a Traditional Compilation to a Management-Use-Only Compilation

.41 The accountant can agree to a request to change in service from a traditional compilation to a management-use-only compilation if (1) he or she does not reasonably expect the financial statements to be used by a third party, (2) nothing comes to the accountant's attention that contradicts management's representation that the financial statements will not be used by a third party, and (3) the accountant documents his or her understanding with the client through the use of a written engagement letter.

Step-Down From a Management-Use-Only Compilation to a Bookkeeping Engagement

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

Communications Between Predecessor and Successor Accountants

.43 SSARS No. 4, as amended (AR section 400), establishes guidance for communication between predecessor and successor accountants. Unlike SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AU section 315), which requires such communication between predecessor and successor auditors, SSARS No. 4 does not require a successor accountant to communicate with a predecessor accountant in connection with acceptance of a compilation or review engagement, but he or she may believe it is beneficial to obtain information that will assist in determining whether to accept the engagement. The successor accountant may consider making inquiries of the predecessor accountant when circumstances such as the following exist:

- Information about the prospective client is limited or requires special attention.

- The change in accountants occurs substantially after the end of the accounting period for which financial statements are to be compiled or reviewed.
- The client has frequently changed accountants.

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

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

Inquiries Regarding Acceptance of the Engagement

.46 If a successor accountant decides to communicate with the predecessor accountant, either orally or in writing, the inquiries should be specific and reasonable regarding matters that will assist the successor accountant in determining whether to accept the engagement. Matters subject to inquiry would include:

- Information that might bear on the honesty or integrity of management.
- Disagreements with management about accounting matters or performance of compilation or review procedures or similarly significant matters.
- Cooperation from management when additional or revised information is needed.
- Predecessor's knowledge of any fraud or illegal acts perpetrated within the client.
- Predecessor's understanding of the reason for the change of accountants.

.47 SSARS No. 4 (AR section 400) does require the predecessor accountant, when authorized by the client, to respond promptly and fully to the inquiries on the basis of known facts. If the predecessor accountant decides, due to unusual circumstances such as impending, threatened, or potential litigation; disciplinary proceedings; or other unusual circumstances, not to respond fully to the inquiries, the predecessor accountant should indicate that the response is limited. (Note that unpaid fees are not considered to be an unusual circumstance for purposes of this paragraph; however, see the paragraph below.) The successor accountant should consider the reasons and consider the implications of such a response in connection with acceptance of the engagement.

.48 If authorized by the client, SSARS No. 4 (AR section 400) states that the predecessor accountant should ordinarily make available certain work papers relating to matters of continuing significance and those relating to contingencies, for example. However, valid business reasons may lead the predecessor accountant to decide not to allow access to the work papers. Unpaid fees constitute a valid business reason to deny access to the predecessor accountant's workpapers. The predecessor accountant may decide to reach an understanding with the successor accountant about the use of the working papers. Before permitting access to the working papers, the predecessor accountant may wish to obtain a written communication from the successor accountant regarding the use of the working papers. The appendix of SSARS No. 4 (AR section 400.12) contains an illustrative successor accountant acknowledgement letter presented for illustrative purposes only and is not required by professional standards. In addition, a predecessor accountant is not obligated to make himself or herself or the work papers available to more than one prospective successor accountant.

Materially Misleading Financial Statements

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

Subsequent Discovery of Facts

.50 After compiling or reviewing a client's financial statements and issuing a report, the accountant may become aware of facts that lead him or her to believe that information supplied by the entity may have been incorrect, incomplete, or otherwise unsatisfactory had the accountant then been aware of such facts. In this case, 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).

.51 You might consider these two factors in determining the appropriate course of action:

- *The reliability of the information.* If the accountant believes that the information is reliable and that it existed at the date of the report, and if the information indicates that the financial statements, the report, or both need revision, the accountant would ordinarily conclude that persons known to be relying on or likely to rely on the financial statements should be notified in an appropriate manner.
- *The existence of persons known to be relying on or likely to rely on the financial statements.* In evaluating the likelihood that users are currently relying on or likely to rely on the financial statements, the accountant should consider the time elapsed since the financial statements were issued.

.52 Because of the legal implications involved in these actions, the accountant should consider consulting with an attorney before proceeding.

Management-Use-Only Financial Statements Distributed to Third Parties

.53 SSARS No. 1 (AR section 100.23) states the following:

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

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

.55 However, if the accountant discovers that the client intentionally disregarded the restriction placed on the use of the financial statements, and if the client refuses to retrieve the financial statements, then he or she should notify known third parties that the financial statements are not intended for third-party use. The accountant also might consider how such an action on the client's part to intentionally disregard the distribution restriction bears on management's integrity and, as a result, on the performance of any further services for that client.

.56 Some practitioners have suggested that the potential risk of third-party distribution is high and, therefore, may avoid performing the management-use-only type of compilation. However, in our profession, there are other restricted-use professional services that are offered (for example, agreed-upon procedures engagements and projections). If the management-use-only engagement is performed correctly, including obtaining a written engagement letter and placing a legend indicating the restricted nature of the presentation on each page of the financial statements, then the risk of third-party distribution should be very low.

Practice Tip

Notification of third parties would involve legal matters beyond the scope of this Manual, therefore, you should consult with an attorney before taking any action. In order to minimize the risk of a client distributing management-use-only financial statements to third parties, the accountant may want to include language in the engagement letter alerting the client to the fact that if he or she needs financial statements for third-party use, that service can be provided separately (see illustrative engagement letter in AAM section 2200.59).

When to Withdraw From an Engagement

.57 The CPA should consider withdrawing from an engagement if any of the following conditions exist:

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

.58

Client Acceptance and Continuance Form—Part I

Client: _____

Financial Statement Date: _____

INSTRUCTIONS:

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

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

CLIENT'S LEGAL NAME:

ADDRESS:

PHONE:

FISCAL YEAR END:

FEDERAL I.D. NO.:

STATE I.D. NO.:

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

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

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:

20 _____ 20 _____ 20 _____ 20 _____ 20 _____

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: _____

.59 Illustrative Engagement Letter for a Compilation of Financial Statements Not Intended for Third Party Use

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

Dear Mr. Gowers:

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

I (We) will perform the following services:

1. I (We) will compile, from information you provide, the *[monthly, quarterly, or other frequency]* financial statements of Gowers Drug Stores for the year 20XX. A compilation is limited to presenting in the form of financial statements information that is the representation of management. I (We) will not audit or review the financial statements and accordingly, will not express an opinion or any other form of assurance on them. The financial statements will not be accompanied by a report.

Based upon my (our) discussions with you, these financial statements are for management's use only and are not intended for third-party use.

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

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

2. I (We) will also *[discussion of other services—optional]*

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

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

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

In view of the limitations described above, you agree not to take or assist in any action seeking to hold me (us) liable for damages due to any deficiency in the financial statements I (we) prepare and you agree to hold me (us) harmless from any liability and related legal costs arising from any third-party use of the financial statements in contravention of the terms of this agreement.—*[optional]*

Our fees for these services *[fill in]*

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

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

Sincerely yours,

[Signature of accountant]

Accepted and agreed to:

Gowers Drug Stores

Title

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 my (our) understanding of the terms and objectives of our engagement . . ."

.60 Illustrative Engagement Letter for a Compilation of Financial Statements

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

Dear Mr. Gowers:

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

1. I (We) will compile, from information you provide, the annual and interim balance sheets and related statements of income, retained earnings, and cash flows of Gowers Drug Stores for the year 20XX. I (We) will not audit or review such financial statements. My (Our) report on the annual financial statements of Gowers Drug Stores is presently expected to read as follows:

I (We) have compiled the accompanying balance sheet of Gowers Drug Stores as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, 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 management. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

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

2. I (We) will also . . . (discussion of other services).

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

My (Our) fees for these services. . . .

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

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

Sincerely yours,

[Signature of accountant]

Accepted and agreed to:

Gowers Drug Stores

Title

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 my (our) understanding of the terms and objectives of our engagement . . ."

.61 Illustrative Engagement Letter for a Review of Financial Statements

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

Dear Mr. Gowers:

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

I (We) will perform the following services:

1. I (We) will review the balance sheet of Gowers Drug Stores as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. My (Our) review will consist primarily of inquiries of company personnel and analytical procedures applied to financial data, and I (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 I (we) will become aware of all significant matters that would be disclosed in an audit. My (Our) engagement cannot be relied upon to disclose errors, fraud, or illegal acts that may exist. However, I (we) will inform the appropriate level of management of any material errors that come to my (our) attention and any fraud or illegal acts that come to our attention, unless they are clearly inconsequential. I (We) will not perform an audit of such financial statements, the objective of which is the expression of an opinion regarding the financial statements taken as a whole, and, accordingly, I (we) will not express such an opinion on them.

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

I (We) have reviewed the accompanying balance sheet of Gowers Drug Stores as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, 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 Gowers Drug Stores.

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.

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

2. I (We) will also . . . [discussion of other services].

My (Our) fees for these services. . . .

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

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

Sincerely yours,

[Signature of accountant]

Accepted and agreed to:

Gowers Drug Stores

Title

Date

.62 Illustrative Engagement Letter for a Bookkeeping Engagement

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

Dear Mr. Gowers:

This letter is to confirm my (our) understanding of the terms and objectives of our engagement and the nature and limitations of the services I (we) will provide. So that I (we) can meet your expectations related to the services we will provide, this engagement letter clearly identifies both the services that will be provided and the frequency with which these services will be provided.

I (We) will prepare semi-monthly payroll checks and compute required withholdings based on hours worked, rates of pay, tax jurisdictions, and withholding information provided by you or your representative. You will need to review all payroll checks prior to signing them, and notify me (us) promptly of any errors. I (We) will notify you of required payroll tax deposits. Failure to make these deposits on a timely basis will subject you to penalties and interest.

I (We) will prepare quarterly and annual payroll tax returns, as well as your annual 1099 forms. You will need to review the returns prior to signing them, and notify me (us) promptly of any errors or omissions.

Any significant changes in the number of employees, various miscellaneous deductions, or other items involved could cause an increase in our fees. I (We) also require that you provide complete information in good "working order" for us, with checks and deposits coded to the proper accounts. I (We) will discuss with you in advance any proposed increase in our fees.

I (We) will also assist you with various bookkeeping functions, including consultation on recordkeeping, recording of transactions, and periodic adjustments, among others.

Our work in connection with this engagement is not intended to result in submission or issuance of financial statements by [Firm] as defined by Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. A submission of financial statements, as defined by professional standards, requires that the CPA present to a client or third parties financial statements that the CPA has prepared manually or through the use of computer software. By your signature below, you understand that the submission of financial statements as defined above is outside the scope of this engagement.

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

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

I (We) appreciate the opportunity to be of service to you and believe that this letter accurately summarizes the significant terms of our engagement. If you have any questions, please let me (us) know. If the foregoing

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

Sincerely yours,

[Signature of accountant]

Accepted and agreed to:

Gowers Drug Stores

Title

Date

[The next page is 2301.]

AAM Section 2300

Compilation Engagements

Type of Compilation

.01 SSARS No. 1 (AR section 100.04) defines a *compilation* as follows:

Presenting in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the statements.

.02 SSARS No. 1 (AR section 100), as amended, now provides for two types of compilations:

- A compilation with a report is required when the accountant has been engaged to compile and report on the financial statements or when the accountant reasonably expects the financial statements to be used by a third party. This might be referred to as a *traditional compilation*.
- A compilation without a report is available when the accountant does not reasonably expect the financial statements to be used by a third party. This might be referred to as a *management-use-only compilation*.

.03 In either case, the engagement is a compilation requiring that the accountant comply with the performance requirements in SSARS No. 1. The difference between the two options lies in the form of communication used in the engagement (see Exhibit 2200.1 in the previous section of this Manual for additional details.)

What's the Difference Between a Traditional Compilation and Management-Use-Only Compilation?

.04 Some practitioners have suggested that there is no real difference between the traditional compilation and the management-use-only compilation since essentially the same information is communicated in either a compilation report or an engagement letter. Although there are similarities in the two forms of communication, there are substantial differences. Both forms of communication (report and engagement letter) are used to communicate:

- *What the engagement is*—in both cases the CPA tells the user that the financial statements are compiled and explains what a compilation is (presenting in the form of financial statements information that is the representation of management).
- *What the engagement is not*—in both cases the CPA tells the user that the financial statements are not audited or reviewed and that no opinion or any other form of assurance is expressed.
- *Limitations in the financial statements*—in both cases the CPA tells the user about any limitations in the financial statements. In this area, however, the way in which limitations are communicated is very different:
 - *Traditional Compilation (Report)*—SSARS No. 1 (AR section 100.41–.42) states that if the accountant becomes aware of a measurement or disclosure departure in the financial statements, the financial statements should be revised or the report should be modified to disclose the departure. In other words, absent revision of the financial statements, the accountant should add an additional paragraph to the report to disclose the nature of the departure and disclose the effect of the departure on the financial statements (if the effect is known).

- *Management-Use-Only Compilation (Engagement Letter)*—SSARS No. 1 (AR section 100.21) states that the accountant should include in the engagement letter a statement that material departures from GAAP or OCBOA may exist and the effects of those departures on the financial statements may not be disclosed.

.05 The reason for this difference in communication is based on the intended user of the financial statements. In the case of a traditional compilation, the financial statements are intended to be used by anyone (general-use). Therefore, the limitations must be communicated in such a way as to be understood by anyone, including those not familiar with the financial matters of the entity. In the case of a management-use-only compilation, the financial statements are intended for a limited group of management (“non third parties”). By definition, these members of management have a certain level of knowledge about the business and about the engagement that the accountant is performing. For that reason, the issue of limitations can be handled in a more broad way (“departures may exist”) rather than specifically identifying each and every known departure.

.06 In an engagement to compile financial statements for management’s use only, a written engagement letter is required. (Note that in all compilation and review engagements an understanding with the client is required.) This engagement letter might address certain matters, as described in AAM section 2200.27. It is permissible to issue one engagement letter to cover multiple periods and/or multiple services. However, it is recommended that this engagement letter be updated at least annually. Because client relationships change over time, it is especially important in this type of engagement to ensure that there is a good understanding between the CPA and the client (restricted nature of the statements, limitations of the financial statements).

Performance Requirements for a Compilation Engagement

.07 SSARS No. 1 (AR section 100), as amended, states that in all compilation engagements, the performance standards in AR section 100.05 and .07–.10 should be followed.

.08 These performance standards consist of:

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

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

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

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

- *Obtain additional or revised information if the information supplied by the client appears to be incorrect, incomplete, or otherwise unsatisfactory.*

This requirement to obtain additional or revised information has different meanings depending upon the intended use of the financial statements. For example, if the financial statements will be used by a

third party (or if the accountant reasonably expects that they might be used by a third party), any information that appears to be incomplete, incorrect, or unsatisfactory for use by that third party (for example, missing disclosures or measurement departures) should be obtained from or corrected by the client. On the other hand, if the financial statements are not intended to be used by third parties, then that same information may be sufficient for management, since they have the requisite knowledge of the business to put the information in the proper context.

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

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

Traditional Compilation

Performance Requirements

.09 In order to perform a traditional compilation, the accountant should

- Establish an understanding with the client (See AAM section 2200.23–.34).
- Have or obtain a general understanding of the accounting principles and practices of the industry in which the client operates.
- Have or obtain a general understanding of the client’s business.
- Obtain additional or revised information if the information supplied by the client appears to be incorrect, incomplete, or otherwise unsatisfactory.
- Read the compiled financial statements and consider whether they appear to be appropriate in form and free of obvious material error.

Reporting Requirements

.10 If the accountant submits financial statements to a client that will be used by a third party (or if he or she reasonably expects that they might be used by a third party), the accountant must comply with the reporting requirements in SSARS No. 1, as amended (AR section 100.11–.19).

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

Management-Use-Only Compilation

Performance Requirements

.12 In order to perform a management-use-only compilation, the accountant should

- Establish an understanding with the client (See AAM section 2200.23–.34).
- Have or obtain a general understanding of the accounting principles and practices of the industry in which the client operates.
- Have or obtain a general understanding of the client’s business.
- Obtain additional or revised information if the information supplied by the client appears to be incorrect, incomplete, or otherwise unsatisfactory.

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

Third Parties

.13 In deciding whether the financial statements are, or reasonably might be, expected to be used by a third party, the accountant may rely on management's representation without further inquiry, unless information comes to his or her attention that contradicts management's representation. SSARS No. 1 (AR section 100.04) defines *third parties* as follows:

All parties except for members of management who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.

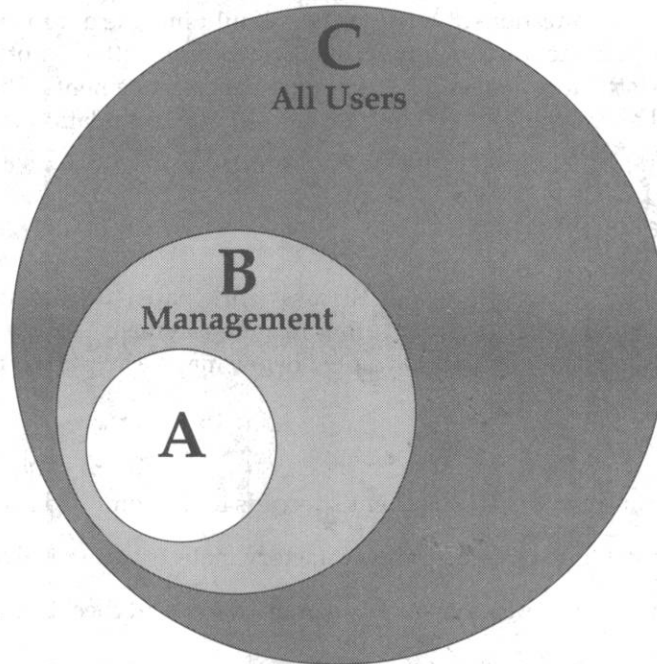
.14 This is a definition by exception. In other words, the starting point for determining who is a third party is that *all parties* are third parties, with the exception of certain members of management. Those certain members of management would be those members who are knowledgeable enough about the business to be able to put the information in the proper context. In order to not be considered a third party, the person or persons must meet two requirements:

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

.15 For guidance on determining whether or not a person is a member of management, the accountant may refer to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, which includes the following definition:

Persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policymaking functions. Persons without formal titles also may be members of management.

.16 In Exhibit 2300.1, "Third Parties," circle C represents all potential users of an entity's financial statements (banks, bonding companies, creditors, shareholders, vendors, customers, and so on), and circle B represents all members of management. All users in circle C would be considered third parties. In addition, members of management in circle B—those without the requisite knowledge of the client's business that would allow them to place the information contained in the financial statements in the proper context—also would be considered third parties. Compiled financial statements which do not include a report should be restricted to those parties in circle A—those members of management who have the requisite knowledge of the business.

Exhibit 2300.1—Third Parties

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

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

- ABC Company is a small, closely-held business, owned and managed by its sole shareholder, John. In this situation, absent evidence to the contrary, John has the requisite knowledge of his business and would not be considered a third party.
- KLM Company is a small, closely-held business, managed by one of its ten shareholders, Jane (the other nine shareholders live out of state and are not involved in the management of the business). In this situation, absent evidence to the contrary, Jane has the requisite knowledge of the business and would not be considered a third party. The other nine shareholders, however, would be considered third parties.
- XYZ Company is a small, closely-held business. The management team consists of a president, Joe; controller, Mary; operations manager, Sue; and sales manager, Jim. Joe, Mary, and Sue are all involved in the financial operation of the company and are knowledgeable about the accounting principles and practices being used. Jim, on the other hand, has no finance background and is not involved in the financial operation of the company. In this example, Joe, Mary, and Sue would not be considered third parties. Jim, although he is a member of management, does not have the requisite knowledge of the accounting practices of the business and would be considered a third party.

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

Transmittal Letter for Management-Use-Only Compilation

.20 Some practitioners have questioned whether they should include a transmittal letter with financial statements compiled for management's use only. While a transmittal letter is not required by SSARSs, it is permissible to attach such a letter to management-use-only financial statements. This letter, however, should not contain any language that resembles that found in a traditional compilation report.

Documentation Requirement

.21 SSARS No. 1 (AR section 100) does not discuss work paper documentation for a compilation engagement except in the case of the engagement letter in a management-use-only compilation.¹ Although not required, including the type of documentation noted below may be helpful from a risk management and quality control perspective:

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

.22 It's wise to document all client discussions, in person or over the phone. Notations should identify all parties to the discussion, what was said, and by whom. Entries should be initiated and dated by the practitioner. Also, consider potential consequences to the client if they ignore, misinterpret, or fail to act on advice or conclusions. If such actions could result in lost financial benefits or adverse tax consequences to the client, or if action by other professionals is recommended or required, send a follow-up letter to the client explaining the substance of the discussions and detailed recommendations.

.23 Never include unsubstantiated subjective statements in a working paper file. If documenting observations regarding questionable client ethics or possible fraud, list the objective findings that led to this observation. In addition, timesheets should reflect and accurately describe work performed during the engagement. Avoid using terms like "audit" and "review," unless the service performed fits the definitions contained in the AICPA professional standards.

Practice Tip

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

¹ SSARS No. 1, as amended by SSARS No. 8 (AR section 100), does require documentation of the understanding with the client in the form of a written engagement letter for a management-use-only compilation (if a compilation report is not to be issued).

.24 Compilation Engagement Program

Client:	Balance Sheet Date:
Completed by:	Date Completed:

Procedure	Completed by or N/A
1. Prepare or update the Client Acceptance and Continuance Form.	
2. Consider whether the firm is independent. If not independent, the compilation report should be modified to indicate that fact.	
3. Establish an understanding with the client, preferably in writing, regarding the nature of the services to be performed. Include a copy of the engagement letter or memorandum describing oral arrangements.	
4. If the engagement was originally intended to be an audit or a review, document the appropriateness of the decision to step-down.	
5. Acquire the necessary knowledge and understanding of:	
a. Accounting principles and practices of the industry.	
b. Nature of the client's business transactions, form of accounting records, stated qualifications of the accounting personnel, accounting basis to be used, and form and content of the financial statements.	
6. Consider the necessity to perform any other accounting services to enable compilation of the financial statements.	
7. If there is any indication that information supplied by the entity is incorrect, incomplete or otherwise unsatisfactory, obtain additional or revised information.	
8. Draft and read the financial statements and consider whether:	
a. The financial statements include all required disclosures, unless substantially all disclosures are omitted.	
b. Financial statements prepared in accordance with an OCBOA present proper OCBOA titles and disclose the basis of accounting either in the notes or in the compilation report.	
c. The financial statements are appropriate in form.	
d. The financial statements are free of obvious mathematical or clerical error.	
e. The financial statements are free of obvious measurement departures from GAAP or OCBOA.	
9. Draft the accountant's report.	
10. If the financial statements omit substantially all disclosures required by GAAP or OCBOA, add an additional paragraph to the report disclosing the omission.	

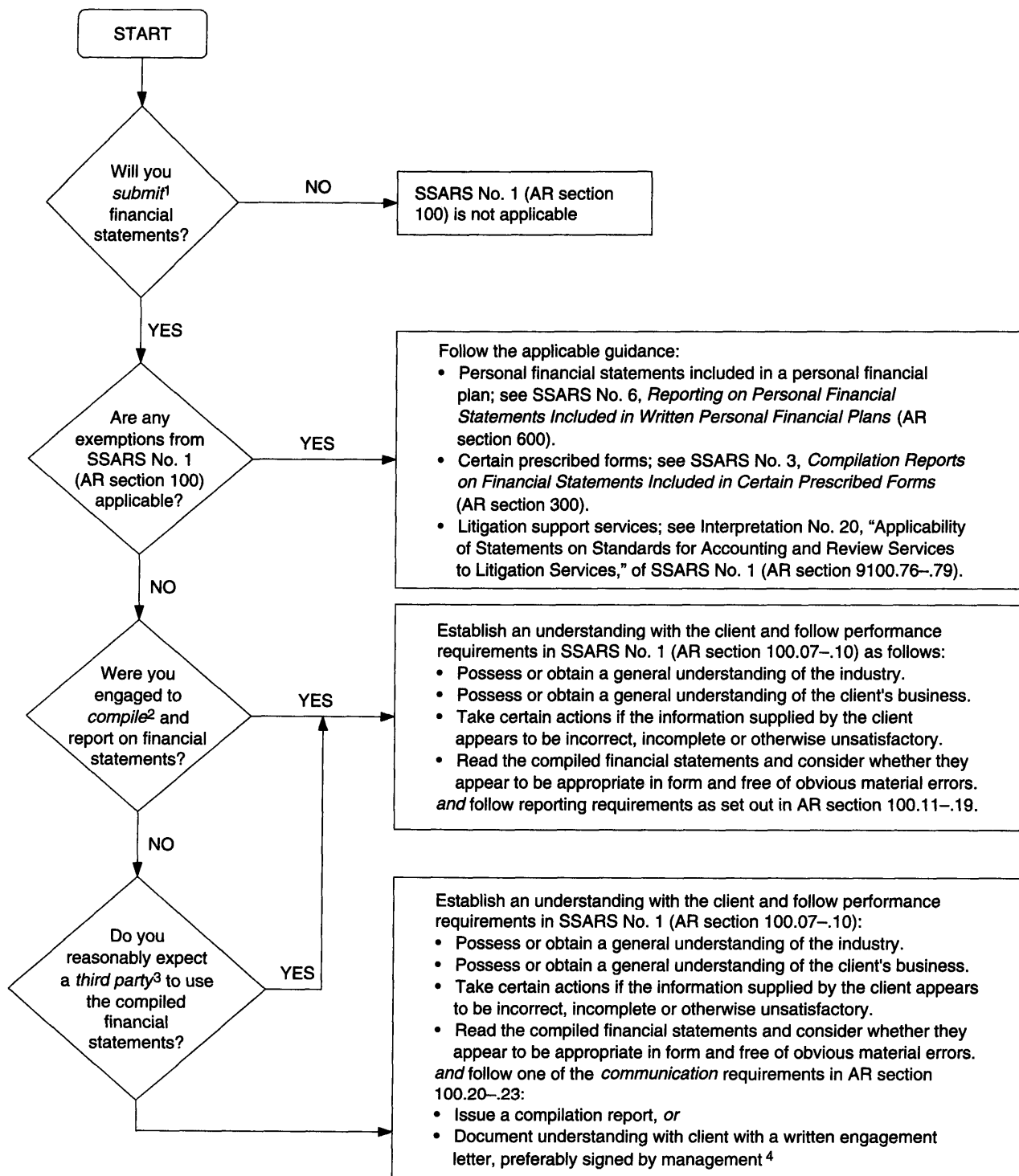
(continued)

Procedure	Completed by or N/A
11. If the financial statements contain a departure from GAAP or OCBOA, including either a measurement or disclosure departure:	
a. Revise the financial statements or modify the report to indicate the departure.	
b. If the financial statements are not revised, consider whether modification of the report is adequate to indicate the deficiencies in the financial statements.	
c. If modification of the report is not considered adequate, consider withdrawing from the engagement.	
12. If supplementary data accompanies the financial statements, consider referring to the other data in the compilation report or issuing a separate report on the other data.	
13. Include a reference to the report on each page of the financial statements and supplementary data.	
14. Document any other procedures performed or unusual problems and their resolution.	
15. Determine that all required forms and checklists have been completed.	
16. Determine that all questions, exceptions, or notes, if any, posed during the work have been followed up and resolved, and review notes and "to do" lists have been removed from the work papers.	
17. Date the report as of the date the compilation was completed.	

Compilation of Financial Statements Flowchart

.25 During the initial development of SSARS No. 8 (AR section 100), the members of Accounting and Review Services Committee designed a flowchart to help guide their discussion about the proposed changes in SSARS No. 1. That flowchart, which appeared in SSARS No. 8, is also useful in explaining how compilation engagements may change due to the issuance of SSARS No. 8. We are including it here with the addition of explanatory notes following.

Exhibit 2300.2—Flowchart of Changes in SSARS No. 1 Resulting From Issuance of SSARS No. 8



¹ *Submission of financial statements*—Presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software.

² *Compilation of financial statements*—Presenting in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the statements.

³ *Third parties*—All parties except for management who are generally knowledgeable and understand the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.

⁴ The engagement letter should include the following matters:

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

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

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

.26 Management-Use-Only Compilation Engagement Checklist

Client:	Balance Sheet Date:
Completed by:	Date Completed:

Procedure	Completed by or N/A
1. Prepare or update the Client Acceptance Form.	
2. Consider whether the firm is independent. If not independent, the engagement letter should be modified to indicate that fact.	
3. Establish an understanding with the client, in writing, regarding the following and include a copy of the engagement letter in the work papers:	
a. Nature and limitations of the services.	
b. A compilation is limited to presenting in the form of financial statements information that is the representation of management.	
c. The financial statements will not be audited or reviewed.	
d. No opinion or any other form of assurance on the financial statements will be provided.	
e. Management has knowledge of the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.	
f. Management representation that financial statements are not to be used by third parties.	
g. Engagement cannot be relied upon to disclose errors, fraud, or illegal acts, and we will inform appropriate level of management of any material errors that come to our attention, unless clearly inconsequential.	
4. If the engagement was originally intended to be another type of engagement, document the appropriateness of the decision to change the engagement.	
5. Acquire the necessary knowledge and understanding of:	
a. Accounting principles and practices of the industry.	
b. Nature of the client's business transactions, form of accounting records, stated qualifications of the accounting personnel, accounting basis to be used, and form and content of the financial statements.	
6. Consider the necessity to perform any other accounting services to enable compilation of the financial statements.	
7. If there is any indication that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory, obtain additional or revised information.	
8. Draft and read the financial statements and consider whether:	
a. The financial statements are appropriate in form.	
b. The financial statements are free of obvious mathematical or clerical error.	

(continued)

Procedure	Completed by or N/A
9. Include a legend on each page of the financial statements and supplementary data indicating the restricted nature of the presentation.	
10. Document any other procedures performed or unusual problems and their resolution.	
11. Determine that all required forms and checklists have been completed.	
12. Determine that all questions, exceptions, or notes, if any, posed during the work have been followed up and resolved, and review notes and "to do" lists have been removed from the work papers.	

[The next page is 2401.]

AAM Section 2400

Review Engagements

Overview

.01 SSARS No. 1 (AR section 100.04) defines a *review* of financial statements as follows:

Performing inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications necessary that should be made to the statements in order for them to be in conformity with GAAP or OCBOA.

.02 The definition of a review assumes the existence of financial statements as a “precedent” to a review engagement. The accountant may have to perform other accounting services or a compilation prior to the review engagement.

.03 The following performance standards are applicable to a review engagement:

- Establish an understanding with the entity regarding the services to be performed and the report the accountant expects to render (See AAM section 2200.23–.34 for a discussion of engagement letters).
- Have, or obtain, knowledge of the accounting principles and practices of the entity’s industry and a general understanding of certain matters related to the entity itself.
- Consider whether it will be necessary to perform other accounting services such as assistance in adjusting the books of account, consultation on accounting matters, or compilation of the financial statements.
- Perform sufficient inquiry and analytical procedures to provide a reasonable basis for expressing limited assurance.
- Take certain actions when the accountant becomes aware that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory.
- Obtain a representation letter from management.
- Document certain items in work papers, as required by SSARS No. 1 (AR section 100.33).

Knowledge of the Industry

.04 SSARS No. 1 requires the accountant to have knowledge of the accounting principles and practices of the industry in which the entity operates. That knowledge, the sources of obtaining it, and the timing requirements are identical to the requirements for a compilation.

.05 The purpose of having that knowledge is not the same, however. In a compilation, the purpose is to “... enable [the accountant] to compile financial statements that are appropriate in form for an entity operating in that industry.” In review, an additional purpose is to assist the accountant in constructing inquiries and analytical procedures adequate to provide a reasonable basis for expressing limited assurance.

Knowledge of the Client

.06 SSARS No. 1 (AR section 100) states that the accountant must possess or obtain a certain knowledge about the entity whose financial statements he is reviewing. Since its basic purpose in a review is to enable the accountant to construct appropriate inquiries and analytical procedures, this level of understanding is more extensive than that required for a compilation engagement.

.07 The accountant who performs a review must have a general understanding of:

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

.08 In order to obtain this understanding, the accountant would need a general knowledge of the entity's:

- Products and services
- Production, distribution, and compensation methods
- Operating locations
- Material transactions with related parties

Necessity to Perform Other Accounting Services

.09 SSARS No. 1 (AR section 100.04) states that "The accountant might consider it necessary to compile the financial statements or to perform other accounting services to enable him to perform a review."

.10 Since the definition of a review assumes the existence of financial statements as a basis for a review, if the statements do not already exist, the accountant may have to prepare books of original entry, post the ledger, prepare a trial balance, and/or compile the financial statements.

.11 In many cases the financial statements may have to be adjusted (accruals, deferrals, depreciation, etc.) before they are reviewed.

Inquiries and Analytical Procedures

.12 In a review engagement, performing inquiries and analytical procedures is the accountant's primary means of obtaining a reasonable basis for expressing limited assurance. Professional literature does not indicate how many procedures must be performed in a given engagement to achieve its reporting objective. That is a matter of professional judgment. The extent of the total knowledge the accountant possesses about an entity and the industry in which it operates is the basis for planning the extent of procedures to be performed.

Review Procedures—Inquiries

.13 SSARS No. 1 (AR section 100.28) states that the accountant's inquiry should ordinarily include:

- Inquiries concerning the entity's accounting principles and practices and the methods followed in applying them.
- Inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements.

- 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.
- 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 (GAAP) 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.

.14 Appendix B of SSARS No. 1 (AR section 100.58) contains illustrative inquiries for a review engagement. However, these illustrative inquiries are not intended to serve as a program or checklist in the conduct of a review. The inquiries to be made in a review engagement are a matter of the accountant's judgment. Specific inquiries should be tailored to the client, based on the accountant's understanding of the client's business and the industry in which it operates.

.15 A list of illustrative inquiries for a review engagement is included in AAM section 2400.38.

Review Procedures—Analytics

.16 SSARS No. 1 (AR section 100.28) states that the accountant's analytical procedures should ordinarily consist of procedures designed to identify relationships and individual items that appear to be unusual. For a review engagement, these procedures fall into three categories:

- Comparison of the financial statements with statements for comparable prior period(s). An example would be trend analysis, which involves the study of the change in accounts over time.
- Comparison of the financial statements with anticipated results, if available (for example, budgets and forecasts). An example would be comparing budgeted amounts to actual amounts and identifying significant variances.
- Study of the relationships of the elements of the financial statements that would be expected to conform to a predictable pattern based on the entity's experience. An example would be reasonableness tests that estimate a financial statement amount or the change in amount from the prior period.

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

.18 Specific analytical procedures used are a matter of the accountant's judgment. Therefore, the accountant should tailor the specific procedures to the client based on his or her understanding of the client's business and the industry in which it operates.

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

- Identify immaterial account balances or classes of transactions. Apply analytical procedures to them, if needed.
- Identify account balances or classes of transactions to which other accounting services (bookkeeping or payroll services, for example) have been applied. Consider the evidence that has been gathered and whether any material errors are likely to remain. If there is already sufficient evidence for those account balances or classes of transactions to reduce the risk of material misstatement to a moderate level, consider whether applying analytical procedures is needed.

- For the remaining account balances and classes of transactions, develop expectations (for example, using historical trends adjusted for known changes) for them. Note, however, that SSARS No. 1 (AR section 100) does not require a formal process of developing and documenting expectations.
- Consider how close the existing account balance or class of transaction comes to the expectation developed in the previous step. If the differences are small, no additional evidence may be needed.
- If the differences are large, material errors could exist. Inquire about valid business reasons for the difference. If the results of inquiry are plausible and agree with other evidence, no additional evidence may be needed.
- If additional evidence is needed, apply other analytical procedures or obtain other suitable evidence.

.20 Overall, the purpose of the inquiries and analytical procedures is to provide the accountant with the primary basis for expressing limited assurance that no material modifications should be made to the financial statements. SSARS No. 1 (AR section 100) does not specify how many procedures must be performed in order to express the limited assurance. The extent and type of procedures performed is a matter of professional judgment.

.21 SSARS No. 1 (AR section 100.31) does allow modification of inquiry and analytical procedures. For example, the accountant may have acquired knowledge about the entity in the performance of audits of the entity's financial statements, compilation of the entity's financial statements, or other accounting services (such as bookkeeping services). This acquired knowledge may be sufficient to reduce the extent of inquiries and analytical procedures, although the accountant would still have the same degree of responsibility with respect to the financial statements (expressing limited assurance that no material modifications should be made to the financial statements).

Analytical Procedures in Initial Review Engagements

.22 Accountants often question how to apply analytical procedures on initial review engagements. For example, how can the accountant evaluate the results of procedures applied for the current year if he or she is unsure whether amounts are comparable with prior years or if the company is newly formed? As stated in the previous section, SSARS No. 1 (AR section 100.31) states:

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

.23 This allows the accountant to modify his or her inquiries and analytical procedures based on knowledge acquired in the performance of other services. Although SSARS No. 1 does not cite initial engagements as a situation in which the accountant may choose to modify his or her inquiries and analytical procedures, it is reasonable to assume that these procedures could be modified in initial engagements.

.24 In initial review engagements, the accountant may have to rely on other sources of evidence. For example, the accountant may have to rely on making additional inquiries. Or, the accountant may have already compiled the financial statements, or may have provided other accounting or bookkeeping services for the client. In these cases the accountant may rely on knowledge gained from these other services to supplement the limited analytical procedures that can be performed because of insufficient history. Also, the accountant's analytical procedures may also consist of comparisons with results for similar clients or to industry statistics, and of analysis of the interrelationships between accounts in these circumstances.

When the Results of Analytical Procedures Are Unfavorable

.25 When results of analytical procedures are unfavorable (i.e., the accountant believes that fluctuations from expected amounts are significant), SSARS No. 1 (AR section 100.32) requires the accountant to apply additional procedures. The accountant must achieve limited assurance that no material modifications are necessary to conform the financial statements to GAAP. Sometimes inquiries and analytical procedures will be sufficient. However, in many cases, the accountant will combine additional inquiry or analytical procedures with preparing other accounting schedules or analyses to explain fluctuations.

.26 Overall, the purpose of the inquiries and analytical procedures is to provide the accountant with the primary basis for expressing limited assurance that no material modifications should be made to the financial statements. SSARS No. 1 (AR section 100) does not specify how many procedures must be performed in order to express the limited assurance. The extent and type of procedures performed is a matter of professional judgment.

.27 An illustrative ratio analysis worksheet is included in AAM section 2400.40, and an illustrative analytical procedures comparative report is included in AAM section 2400.41.

Awareness Concerning Information Supplied

.28 SSARS No. 1 (AR section 100.32) states that a review does not contemplate various procedures that are ordinarily performed during an audit. However, it goes on to state that “. . . if the accountant becomes aware that information coming to his attention is incorrect, incomplete, or otherwise unsatisfactory, he should perform the additional procedures he deems necessary to achieve limited assurance . . .”

.29 If the accountant is unable to perform the inquiry and analytical procedures he considers necessary to achieve limited assurance contemplated by a review, his review will be incomplete. Under these circumstances, the accountant will not have attained his original objective and accordingly cannot express limited assurance.

.30 SSARS No. 1 (AR section 100.38) also states that “when an accountant is unable to perform the inquiry and analytical procedures he or she considers necessary . . . the review will be incomplete.” A review that is incomplete is not an adequate basis for issuing a review report. In such a situation, the accountant should also consider whether it is appropriate to issue a compilation report on the financial statements.

Representation Letters

.31 Written representations are required from management for all financial statements and periods covered by the accountant’s review report. The specific written representations obtained by the accountant will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. In connection with the review of the financial statements presented in accordance with GAAP, specific representations should relate to the following matters:¹

- Management’s acknowledgement of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity generally accepted accounting principles.
- Management’s belief that the financial statements are fairly presented in conformity with generally accepted accounting principles.
- Management’s full and truthful response to all inquiries.

¹ Specific representations also are applicable to financial statements presented in conformity with a comprehensive basis of accounting other than generally accepted accounting principles. The specific representations to be obtained should be based on the nature and basis of representation of the financial statements being reviewed.

- Completeness of information.
- Information concerning subsequent events.

.32 Like the inquiries and analytical procedures in a review engagement, the management representation letter should be tailored to the client based on the accountant's knowledge of the client's business and the industry in which it operates. Additional representations may be added to the letter, especially if the client operates in a specialized industry (e.g., construction contractors, homeowners associations, and not-for-profit organizations). These additional representations may be found in *AICPA Industry Audit and Accounting Guides* you can obtain by contacting AICPA Member Services at 888-777-7077.

.33 The written representations should be addressed to the accountant. The representations should be made as of a date no earlier than the date of the accountant's report since the accountant is concerned with events occurring through the date of the report that may require adjustments to or disclosure in the financial statements. The letter should be signed by those members of management whom the accountant believes are responsible for and knowledgeable, directly or through others in the organization, about the matters covered in the representation letter. Normally the chief executive officer and chief financial officer or others with equivalent positions in the entity should sign the representation letter. If the current management was not present during all the periods covered by the accountant's report, the accountant should nevertheless obtain written representations from current management on all such periods.

.34 An illustrative management representation letter is provided in Appendix F of SSARS No. 1 (AR section 100.62) and is included in AAM section 2400.38.

Work Paper Documentation

.35 SSARS No. 1 (AR section 100.33) does not specify the form and content of work papers for review engagements, but it does state that they should describe the following:

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

.36 In addition, most practitioners include some or all of the following in their work papers:

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

.37 Review Engagement Program

Client:	Balance Sheet Date:
Completed by:	Date Completed:

Procedure	Completed by or N/A
1. Prepare or update the Client Acceptance and Continuance Form.	
2. Consider whether the firm is independent. If not independent, a review engagement cannot be performed.	
3. Establish an understanding with the client, preferably in writing, regarding the nature of the services to be performed. Include a copy of the engagement letter or memorandum describing oral arrangements.	
4. If the engagement was originally intended to be an audit, document the appropriateness of the decision to step-down.	
5. Acquire the necessary knowledge and understanding of:	
a. Accounting principles and practices of the industry.	
b. Nature of the client's business transactions, form of accounting records, stated qualifications of the accounting personnel, accounting basis to be used, and form and content of the financial statements.	
6. Consider the necessity to perform any other accounting services to enable review of the financial statements.	
7. Perform the following inquiries and analytical procedures:	
a. Inquire as to the accounting principles and practices and the methods followed in applying them.	
b. Inquire as to the procedures for recording, classifying, and summarizing transactions and accumulating information for financial statement disclosures.	
c. Identify relationships and individual items that appear to be unusual.	
d. Inquire as to actions taken at meetings of stockholders and directors.	
e. Inquire of persons having responsibility for financial and accounting matters concerning:	
1) Whether the financial statements have been prepared in accordance with GAAP (or an OCBOA) consistently applied.	
2) Changes in the client's business activities or accounting principles and practices.	
3) Matters as to which questions have arisen in the course of applying the inquiry and analytical procedures.	
4) Events subsequent to the date of the financial statements that would have a material effect on the financial statements.	
8. If there is any indication that information supplied by the entity is incorrect, incomplete or otherwise unsatisfactory, obtain additional or revised information.	

(continued)

Procedure	Completed by or N/A
9. Draft and read the financial statements and consider whether:	
a. The financial statements include all required disclosures.	
b. Financial statements prepared in accordance with an OCBOA present proper OCBOA titles and disclose the basis of accounting either in the notes or in the review report.	
c. The financial statements are appropriate in form.	
d. The financial statements are free of obvious mathematical or clerical error.	
e. The financial statements are free of obvious measurement departures from GAAP or OCBOA.	
10. Draft the accountant's report.	
11. If the financial statements contain a departure from GAAP or OCBOA, including either a measurement or disclosure departure:	
a. Revise the financial statements or modify the report to indicate the departure.	
b. If the financial statements are not revised, consider whether modification of the report is adequate to indicate the deficiencies in the financial statements.	
c. If modification of the report is not considered adequate, consider withdrawing from the engagement.	
12. Obtain a representation letter.	
13. If supplementary data accompanies the financial statements, modify the report in accordance with AR section 100.45.	
14. Include a reference to the report on each page of the financial statements and supplementary data.	
15. Document any other procedures performed or unusual problems and their resolution.	
16. Determine that all required forms and checklists have been completed.	
17. Determine that all questions, exceptions, or notes, if any, posed during the work have been followed up and resolved, and review notes and "to do" lists have been removed from the work papers.	
18. Date the report as of the date the review was completed.	

.38 Review of Financial Statements—Illustrative Representation Letter

A review of financial statements consists principally of inquiries of company personnel and analytical procedures applied to financial data. As part of a review of financial statements, the accountant is required to obtain a written representation from his or her client to confirm the oral representations made to the accountant. The introductory paragraph should specify the financial statements and periods covered by the accountant's review report. If matters exist that should be disclosed to the accountant, they should be indicated by listing them following the representation. The following representation letter is included for illustrative purposes only. The accountant may decide, based on the circumstances of the review engagement or the industry in which the entity operates, that other matters should be specifically included in the letter and that some of the representations included in the illustrative letter are not necessary.

(Date [No earlier than the date of the Accountant's Report])

(To the Accountant)

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

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

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.¹

We confirm, to the best of our knowledge and belief, (as of [a date no earlier than the date of review report, see section 100.29]), the following representations made to you during your review.

1. The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.
2. We have made available to you all:
 - a. Financial records and related data.
 - b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
4. We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.
5. 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.
6. There are no:
 - a. Violations or possible violations of laws or regulations, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

¹ The qualitative discussion of materiality used in this letter is adapted from (FASB) Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

- We believe that the carrying amounts of all material assets will be recoverable.
- All agreements to repurchase assets previously sold have been properly disclosed.
- We have made provisions for losses to be sustained in the fulfillment of, or from the inability to fulfill sales commitments.

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

(Name of Owner or Chief Executive Officer and Title)

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

See SAS No. 85, *Management Representations*, Appendix B, "Additional Illustrative Representations" (AU section 333.17), for other representations that may be appropriate from management relating to matters specific to the entity's business or industry.

.39 Review of Financial Statements—Illustrative Inquiries

1. General
 - a. What are the procedures for recording, classifying, and summarizing transactions (relates to each section discussed below)?
 - b. Do the general ledger control accounts agree with subsidiary records (for example, receivables, inventories, investments, property and equipment, accounts payable, accrued expenses, noncurrent liabilities)?
 - c. Have accounting principles been applied on a consistent basis?
2. Cash
 - a. Have bank balances been reconciled with book balances?
 - b. Have old or unusual reconciling items between bank balances and book balances been reviewed and adjustments made where necessary?
 - c. Has a proper cutoff of cash transactions been made?
 - d. Are there any restrictions on the availability of cash balances?
 - e. Have cash funds been counted and reconciled with control accounts?
3. Receivables
 - a. Has an adequate allowance been made for doubtful accounts?
 - b. Have receivables considered uncollectible been written off?
 - c. If appropriate, has interest been reflected?
 - d. Has a proper cutoff of sales transactions been made?
 - e. Are there any receivables from employees and related parties?
 - f. Are any receivables pledged, discounted, or factored?
 - g. Have receivables been properly classified between current and noncurrent?
4. Inventories
 - a. Have inventories been physically counted? If not, how have inventories been determined?
 - b. Have general ledger control accounts been adjusted to agree with physical inventories?
 - c. If physical inventories are taken at a date other than the balance sheet date, what procedures were used to record changes in inventory between the date of the physical inventory and the balance sheet date?
 - d. Were consignments in or out considered in taking physical inventories?
 - e. What is the basis of valuation?
 - f. Does inventory cost include material, labor, and overhead where applicable?
 - g. Have write-downs for obsolescence or cost in excess of net realizable value been made?
 - h. Have proper cutoffs of purchases, goods in transit, and returned goods been made?
 - i. Are there any inventory encumbrances?
5. Prepaid expenses
 - a. What is the nature of the amounts included in prepaid expenses?
 - b. How are these amounts amortized?

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

11. Income and other taxes

- a.* Has provision been made for current and prior-year federal income taxes payable?
- b.* Have any assessments or reassessments been received? Are there tax examinations in process?
- c.* Are there timing differences? If so, have deferred taxes been reflected?
- d.* Has provision been made for state and local income, franchise, sales, and other taxes payable?

12. Other liabilities, contingencies, and commitments

- a.* What is the nature of the amounts included in other liabilities?
- b.* Have other liabilities been properly classified between current and noncurrent?
- c.* Are there any contingent liabilities, such as discounted notes, drafts, endorsements, warranties, litigation, and unsettled asserted claims? Are there any unasserted potential claims?
- d.* Are there any material contractual obligations for construction or purchase of real property and equipment and any commitments or options to purchase or sell company securities?

13. Equity

- a.* What is the nature of any changes in equity accounts?
- b.* What classes of capital stock have been authorized?
- c.* What is the par or stated value of the various classes of stock?
- d.* Do amounts of outstanding shares of capital stock agree with subsidiary records?
- e.* Have capital stock preferences, if any, been disclosed?
- f.* Have stock options been granted?
- g.* Has the entity made any acquisitions of its own capital stock?
- h.* Are there any restrictions on retained earnings or other capital?

14. Revenue and expenses

- a.* Are revenues from the sale of major products and services recognized in the appropriate period?
- b.* Are purchases and expenses recognized in the appropriate period and properly classified?
- c.* Do the financial statements include discontinued operations or items that might be considered extraordinary?

15. Other

- a.* Are there any events that occurred after the end of the fiscal period that have a significant effect on the financial statements?
- b.* Have actions taken at stockholder, board of directors, or comparable meetings that affect the financial statements been reflected?
- c.* Have there been any material transactions between related parties?
- d.* Are there any material uncertainties? Is there any change in the status of material uncertainties previously disclosed?

.40 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	=
<hr/>			
Altman Z Score			<hr/> <hr/>

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	=
<hr/>			
Altman Z Score			<hr/> <hr/>

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			<hr/>
Altman Z Score			<hr/> <hr/>

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

.41 Illustrative Analytical Procedures Comparative Report

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

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					

[The next page is 2501.]

AAM Section 2500

Form and Content of Financial Statements

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

Title Page

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

Name of the Entity

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

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

Title of Financial Statements

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

Date or Period Covered

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

Presentation of the Accountant's Report

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

Letterhead

.07 There is no requirement that the accountant's report be printed on the firm's letterhead (nor is there any requirement that the report be manually signed* or that the financial statements be bound).

Heading of the Accountant's Report

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

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

Address

.09 Generally, the accountant's report should be addressed to the Board of Directors, stockholders, or both. Reports are not intended as letters. Accordingly, addresses that include street names or zip codes are not appropriate. Examples of appropriate addresses are as follows:

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

Salutations

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

* The Accounting and Review Services Committee has issued a proposed SSARS, *Omnibus—2002*. The proposed omnibus statement includes revisions to existing SSARS that have been accumulated over time, including possible revisions relating to information presented here. For a summary of the omnibus statement, see AAM section 2100.54.

Signature

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

Date of Report

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

Basic Financial Statements

.13 The basic financial statements included in a GAAP financial statement presentation are as follows: (Note: Basic financial statements for an OCBOA presentation are discussed in AAM section 2700)

- Balance Sheet
- Income Statement
- Statement of Retained Earnings* or Changes in Stockholders' Equity
- Statement of Cash Flows

Heading

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

Reference on Financial Statements

- .15 The type of reference/legend on the financial statements depends upon the type of engagement:
- If the financial statements are reviewed, each page of the financial statements should contain a reference, such as: *See Accountant's Review Report.*
 - If the financial statements are compiled for general-use (i.e., not restricted to management's use only), each page of the financial statements should contain a reference, such as: *See Accountant's Compilation Report.*
 - If the financial statements are compiled for management's use only, each page of the financial statements should contain a reference to the restricted nature of the financial statements, such as:
 - *Restricted for Management's Use Only, or*
 - *Solely for the information of and use by the management of XYZ Company and not intended to be and should not be used by any other party.*
 - If the financial statements are compiled and included in certain prescribed forms (according to SSARS No. 3 [AR section 300]), each page of the form should include a reference, such as: *See Accountant's Compilation Report.*
 - If the financial statements are personal financial statements prepared for inclusion in a personal financial plan (SSARS No. 6 [AR section 600]), each of the personal financial statements should contain a reference to the report, such as: *See Accountant's Report.*

* The accounting literature does not require the statement of retained earnings to be presented as a financial statement. Accounting Principles Board (APB) Opinion No. 12, *Omnibus Opinion—1967*, requires the disclosure of a change in capital. This can be accomplished by the preparation of a separate statement, in the notes to the financial statements, or as part of another basic statement. If the accountant does not include a statement of retained earnings as a separate statement, reference in the compilation report is not needed.

.16 Note that, in all cases, these requirements extend to the footnotes (since the footnotes are part of the financial statements). However, there is diversity in practice as to how to meet this requirement for footnotes. Some practitioners place the reference on each page of the footnotes, and others place the reference only on the first page of the footnotes. Still others place a statement on each page of the financial statements that “the notes are an integral part of the financial statements” and, therefore, do not place the reference on the footnote pages. Any of these approaches is acceptable.

.17 Also, the references above are examples given in SSARS, and the accountant may modify the wording of the reference. SSARS No. 1 (AR section 100) requires only that the accountant refer to the report—not that he or she state the type of report (level of service) in the reference. Therefore, the reference “See Accountant’s Report” would be sufficient in all engagements that contain a report. However, most practitioners follow the wording given in the examples. Accountants may place the reference on the financial statements by installing footers in the financial statement software, by using a rubber stamp, by manually writing the reference or by any other method that is practical to use.

Use of the Term “Unaudited”

.18 Some practitioners follow the financial statement title with the term “Unaudited.” This practice is not required by SSARS and may be misleading.

Supplementary Information

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

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

Presentation

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

Reporting

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

Headings

.22 Each schedule should be headed with a descriptive title that distinguishes it from the basic financial statements. Normally, supplementary schedules are not referred to as “statements” to avoid confusing them with basic financial statements.

Reference to Report

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

Disclosures

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

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

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

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

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

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

Referencing Notes

.28 While there is no requirement that individual notes be referenced to specific items in the financial statements, each page of the financial statements should contain a general reference to the notes. If “selected information” rather than all notes is presented in a compilation, a reference to the selected information should be included.

[The next page is 2551.]

AAM Section 2600

Reporting

Reporting Obligation

.01 SSARS No. 1 (AR section 100) discusses the accountant's reporting obligation for compilation and review engagements. In summary, it says:

- A compilation is the minimum level of service that an accountant can provide before submitting unaudited financial statements of a nonpublic entity to a client or others (AR section 100.01)
- The accountant should not consent to the use of his or her name in a document or written communication containing unaudited financial statements of a nonpublic entity unless (a) the accountant has compiled or reviewed the financial statements in compliance with the provisions of SSARS No. 1 (AR section 100), or (b) the financial statements are accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that the accountant assumes no responsibility for them. For example, the indication may be worded as follows:

The accompanying balance sheet of X Company as of December 31, 20X1, the related statements of income, and cash flows for the year then ended were not audited, reviewed, or compiled by us and, accordingly, we do not express an opinion or any other form of assurance on them. (AR section 100.03, as amended by SSARS No. 9)

- The accountant should issue a report prepared in accordance with SSARS whenever he or she is engaged to compile financial statements of a nonpublic entity, or submits financial statements that are reasonably expected to be used by a third party (AR section 100.11, as amended by SSARS No. 9)
- The accountant should issue a report prepared in accordance with SSARS whenever he or she is engaged to review financial statements of a nonpublic entity (AR section 100.34, as amended by SSARS No. 9)

.02 The first item in the bulleted list above is addressed in SSARS No. 1 (AR section 100.01). Whenever the accountant prepares financial statements (manually or using a computer) and presents them to a client or third parties, he or she has submitted financial statements. When this occurs, the accountant must at least perform a compilation.

.03 The second item in the bulleted list in paragraph .01 of this section is aimed at situations when a client includes the accountant's name in a loan proposal, prospectus, or other written communication that includes client-prepared financial statements. If the client uses financial statements that were previously compiled or reviewed by the accountant, the accountant should insist that his report accompany the statements. If the financial statements are client-prepared, the accountant must insist either that the reference to his name be removed or that the statements be accompanied by an indication that he has not compiled or reviewed them and takes no responsibility for them.

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

Basic Compilation Reports

.05 A report on compiled financial statements should contain the following basic elements:

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

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

Basic Review Reports

.07 Financial statements reviewed by an accountant should be accompanied by a report which includes the following basic elements:

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

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

Reporting When Not Independent

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

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

We are not independent with respect to XYZ Company.

Reporting on Financial Statements That Omit Disclosures

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

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

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

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

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

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

.15 Interpretation No. 1 of SSARS No. 1 (AR section 9100.01) indicates that the above modification for compiled financial statements is not appropriate for reviewed financial statements. Since the omission of substantially all disclosures is a departure from GAAP, the review report should include the omitted disclosures.

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

Reporting on Financial Statements With Departures From GAAP

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

- Persuade the client to revise the financial statements to conform to GAAP
- Refer to the departure in the report
- Withdraw from the engagement

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

Reporting When There Are Significant Departures From GAAP

.19 According to Interpretation No. 7 of SSARS No. 1 (AR section 9100.23–.26), an accountant cannot modify a compilation or review report to indicate that the financial statements are not fairly presented in accordance with GAAP. Thus, an adverse opinion is not appropriate in a compilation or review engagement. An adverse opinion can only be expressed in an audit engagement.

.20 The interpretation indicates that the accountant may wish to emphasize the limitations of financial statements having significant GAAP departures (whether disclosure or measurement) in a separate paragraph in the report. This paragraph is in addition to the one that describes the departure. Suggested wording for such a paragraph follows:

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

Date of Reports

.21 The date of the completion of the accountant's review procedures should be used as the date of his or her report on reviewed financial statements. The date of completion of the compilation should be used as the date of his or her report on compiled financial statements. Most accountants believe that the completion of a compilation generally takes place on the date the financial statements are "read."

Highest Level of Service

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

.23 Interpretation No. 3 of SSARS No. 1 (AR section 9100.06–.12) provides guidance on the type of report to be issued when the accountant performs procedures that go beyond those required. It states that simply performing procedures (e.g., analytical procedures in a compilation engagement) do not require the issuance of the higher report.

.24 Interpretation No. 13 of SSARS No. 1 (AR section 9100.46–.49) addresses whether an accountant can perform audit procedures in a compilation or review engagement and still issue a compilation or review report. It states that this is acceptable. But the report should not reference the additional procedures performed.

.25 Both interpretations stress the importance of the understanding with the client.

.26 An exception to the highest level of service rule is indicated in SSARS No. 1 (AR section 100.40). If the accountant is engaged to perform an audit or a review, but finds that he or she is not independent, the auditor may issue a compilation report.

.27 SSARS No. 3 (AR section 300) permits another exception to the highest level of service rule). It allows an accountant who has reviewed financial statements to issue a compilation report on financial statements for the same period included in a prescribed form.

Performing a Lower Level of Service

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

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

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

Reporting When the Statement of Cash Flows and/or Comprehensive Income Information Is Omitted

.30 Financial Accounting Standards Board (FASB) Statement No. 95, *Statement of Cash Flows*, requires that a statement of cash flows be presented for each period for which an income statement is presented. Thus, omitting the statement of cash flows constitutes a departure from GAAP. Like other departures from GAAP, the accountant must disclose the departure in a separate paragraph of his report. An example wording of the separate paragraph follows:

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

.31 According to FASB Statement No. 130, *Reporting Comprehensive Income*, all business entities that have any component of comprehensive income must display information about comprehensive income in a financial statement having the same prominence as the other basic financial statements. The primary components of other comprehensive income include:

- Unrealized gains and losses arising from investments in marketable securities classified as “available for sale” (FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*).
- Foreign currency translation adjustments, and gains and losses from certain foreign currency transactions (FASB Statement No. 52, *Foreign Currency Translation*).
- Minimum pension liability adjustments (FASB Statement No. 87, *Employers’ Accounting for Pensions*).
- Unrealized gains and losses arising from certain derivative transactions (FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*).

.32 If an entity does not have components of other comprehensive income, FASB Statement No. 130 does not apply. As a result, most small business clients do not have to apply FASB Statement No. 130. The requirements of FASB Statement No. 130 do not apply to not-for-profit organizations that are required to follow the provisions of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*.

.33 FASB Statement No. 130 does not specify a format for presenting comprehensive income, although it provides three examples:

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

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

.35 However, in compiled financial statements, the presentation of comprehensive income may be omitted by identifying the omission (in much the same way that a statement of cash flows is omitted). Depending on the type of engagement, the omission will be identified in the report accompanying the financial statements or in the engagement letter (management-use only financial statements).

Reporting When Supplementary Information Is Included

.36 Two common questions arise when supplementary information is included with the basic financial statements:

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

.37 The term “supplementary information” is not defined in SSARS. SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AU section 551) defines this type of information as:

- Additional details of items in, or related to, the basic financial statements, unless the information has been identified as being part of the basic financial statements
- Consolidating information
- Historical summaries of items extracted from basic financial statements, including graphs prepared on a computer
- Statistical data
- Other material, some of which may be from sources outside the accounting system or outside the entity

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

- Budgets for an expired period
- Cost of goods sold schedule
- Manufacturing expenses schedule
- Selling expenses
- General and administrative expenses

- Details of marketable securities
- Property and equipment schedule
- Aging analysis of accounts receivable
- Details of sales by product line, territory, or salesman

.39 Normally, supplementary information is separated from the basic financial statements. Most practitioners present supplementary information on separate pages after the basic financial statements (and footnotes, if included). It is also a good idea to separate the supplementary information from the basic financial statements by including a title page marked: "Supplementary Information." If the accountant presents a separate report on the supplementary information, it should follow the title page.

.40 SSARS No. 1, as amended by SSARS No. 9 (AR section 100.45), requires that the accountant indicate the degree of responsibility, if any, he or she is taking with respect to the supplementary information that accompanies the basic financial statements.

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

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

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

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

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

.43 In any case, the important thing to remember is to clearly indicate the degree of responsibility the accountant is taking for any information accompanying the basic financial statements.

Client-Prepared Supplementary Information

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

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

Client-Prepared Supplementary Information Bound in the Accountant's Report Cover

.45 When the client-prepared supplementary information is bound in the accountant's report cover, a third party would normally conclude that the accountant has some responsibility for the information. Thus, in such a situation, being silent about the accountant's responsibility for the client-prepared supplementary information is not a valid alternative. SSARS No. 1 (AR section 100.45) states, "When the basic financial statements are accompanied by information presented for supplementary analysis purposes, the accountant should clearly indicate the degree of responsibility, if any, he is taking with respect to such information."

Supplementary Information Attached by the Client

.46 The accountant's reporting responsibility for client-prepared supplementary information attached to the financial statements after they are delivered to the client is not directly addressed by SSARS. Realistically, the accountant has little control over the client's actions once he or she delivers the report. However, situations do occur when the client clearly communicates to the accountant that the financial statements will be combined with other client-prepared information and submitted by the client to third parties, e.g., to a bank as part of a loan proposal package. In fact, the accountant may accompany the client when he or she submits the package to the third party. Guidance for these situations can be inferred from SSARS No. 1 (AR section 100) and SSARS No. 2 (AR section 200), that discusses client-prepared financial statements included in a client-prepared document along with compiled or reviewed financial statements. Basically, this guidance says the client-prepared financial statements should be accompanied by a statement that they were not prepared by the accounting firm and the accounting firm assumes no responsibility for them. Absent such a statement, the accountant is advised to consult with his attorney to consider what other actions are appropriate. In such situations, the accountant should ask the client to disclose (preferably on a page immediately preceding the data) a statement such as the following:

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

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

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

Percentages

.48 Percentages presented in the financial statements (as is commonly the case with computer-generated statements) do not constitute supplementary information for purposes of the reporting requirements of

SSARS No. 1 (AR section 100). Accordingly, the accountant should not mention the percentages in the report. A related question is whether the inclusion of such percentages implies the accountant has performed analytical procedures and, thus, must report on the financial statements as if it were a SSARS review engagement. Most would argue that this is not the case.

Forecast or Projection Included With Historical Financial Statements

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

.50 An exception to this rule occurs for expired forecasts or projections, i.e., presentations that are no longer prospective in nature because the prospective period has expired. An example would be 2002 historical financial statements presented alongside an expired 2002 budget. Expired prospective information presented for comparative purposes meets the definition of supplementary information; therefore SSARS No. 1 (AR section 100) applies.

Pro Forma Information

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

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

.52 Although such future or hypothetical transactions may appear prospective in nature, pro forma presentations are essentially historical financial statements that have been recast. SSARS guidance on pro forma financial information is limited.

.53 Typically, accountants' association with pro forma financial information should be restricted to situations where the pro forma information is treated as supplementary information, and the reporting guidance in SSARS No. 1 (AR section 100) should be followed.

.54 The document presenting pro forma information should include complete historical financial statements. Usually, the pro forma information will be presented as notes or supplementary information to the historical financial statements.

Supplementary Information Presented Without Financial Statements

.55 Since stand-alone supplementary information will ordinarily not constitute a full financial statement, the accountant has no reporting responsibility under SSARS. However, the guidance above can generally be followed if the accountant is asked to report on supplementary information that is to be presented without financial statements.

Reporting on Charts and Graphs

General

.56 Common examples of charts and graphs prepared for clients include:

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

Charts and Graphs That Accompany Financial Statements

.57 When the basic financial statements are accompanied by information in the form of a chart or graph, such information should be considered supplementary information. These basic issues that should be considered:

- Accountants should check for consistency if the same information is presented numerically in the basic financial statements and graphically in supplementary information
- Accountants should consider whether the information is presented in a way that is obviously misleading
- Due to the subjective nature of graphic presentations, accountants will ordinarily elect to report on them as compiled—even when they accompany reviewed financial statements
- Each chart or graph should include a reference to the accountant's report.

Stand-Alone Charts and Graphs

.58 Unless the stand-alone chart or graph constitutes a complete financial statement (which would be rare), the accountant has no reporting responsibility. The type of financial information depicted in charts and graphs (that is, whether they are considered specified elements or condensed financial information) determines how accountants should report if they elect to do so.

Emphasis Paragraphs

.59 Footnote 23 of SSARS No. 1 (AR section 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." In other words, footnote 23 permits, but never requires, an emphasis paragraph (as long as the matter is appropriately disclosed in the financial statements). 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.

.60 If the accountant decides to add an emphasis paragraph, he or she should follow these guidelines:

- Emphasis paragraphs should not introduce new information about the financial statements; they should only emphasize a matter that is disclosed in the financial statements.
- 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. This required paragraph differs from a voluntary emphasis paragraph.

- Emphasis paragraphs should not contain information about the procedures the accountant has or has not performed.
- Emphasis paragraphs should not contain any conclusions or opinions.
- If the accountant decides to add an emphasis paragraph to highlight a going-concern disclosure in the client's financial statements, he or she should not use the term "substantial doubt" in that paragraph (Substantial doubt is an audit-evidence-based concept that should only be used in audit reports.)

Going Concern Issues

.61 According to Interpretation No. 11 of SSARS No. 1 (AR section 9100.33–.40) and footnote 23 of SSARS No. 1 (AR section 100), the accountant should consult SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341.10–.11), to evaluate the adequacy of disclosure of uncertainties caused by concern about the entity's ability to continue as a going concern. If, based on SAS No. 59, the accountant believes that the financial statement disclosure of the uncertainty is inadequate, he or she should consider modifying the report. See the preceding "Emphasis Paragraphs" section above for further information.

Full Disclosure Financial Statements

.62 As discussed earlier, footnote 23 of SSARS No. 1 (AR section 100) permits, but never requires, an emphasis paragraph (as long as the matter is appropriately disclosed in the financial statements). If the accountant decides to add a paragraph to emphasize a going concern matter, Interpretation 11 of SSARS No. 1 (AR section 9100.33) contains illustrative language that he or she may use:

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.

Omission of Substantially All Disclosures

.63 The accountant may compile financial statements for a client that omit substantially all disclosures required by GAAP or OCBOA, provided that the omission is clearly indicated in the report and is not, to the accountant's knowledge, undertaken with the intention of misleading those who might reasonably be expected to use such financial statements.¹

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

.65 Although not required, the going concern matter can be disclosed. In this case, however, the disclosure should be made in the financial statements. Keep in mind that emphasis paragraphs should not introduce new information about the financial statements. Rather, they should only emphasize a matter that is already disclosed in the financial statements. If the going concern matter is the only disclosure included in the financial statements, it should be labeled as "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included," rather than "Notes to the Financial Statements." Once disclosed in the financial statements, the matter can then be emphasized, if the accountant desires, in a separate paragraph of the report.

¹ Note that the accountant cannot review financial statements that omit substantially all disclosures.

Reporting on Computer-Prepared Financial Statements

.66 Computer-prepared financial statements for interim or annual periods that contain disclosure omissions or measurement departures must be reported on in accordance with SSARS No. 1 (AR section 100). The accountant cannot place a legend on computer-prepared financial statements saying that the statements were not compiled, reviewed, or audited by an accountant and thereby avoid the reporting requirements of SSARS No. 1.

Reporting When There Is a Scope Limitation

.67 Scope limitations occur in audit engagements when the auditor is prevented from applying GAAS because of limitations imposed by the client or caused by circumstances. When an auditor encounters a scope limitation, he or she issues an “except for” opinion or disclaimer of opinion. However, SSARS No. 1 (AR section 100) does not permit such reporting.

.68 Scope limitations can occur in SSARS engagements, especially in initial review engagements. In those cases, it is not unusual for the accountant to raise questions about the reasonableness of amounts included in the financial statements. Often, due to the timing of the engagement or inadequate accounting records, he or she may also be unable to apply analytical procedures to obtain review assurance. SSARS No. 1 (AR section 100.38) notes that when an accountant is unable to perform inquiry and analytical procedures necessary for a review or when the client does not furnish a representation letter, the review will be incomplete and a review report cannot be issued. In this situation, the accountant should consider whether the scope limitation also precludes him or her from issuing a compilation report.

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

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

.70 In deciding whether it would be appropriate to issue a compilation report when a scope restriction precludes a review report, the accountant should determine if the scope restriction is client-imposed. SSARS No. 1 (AR section 100.09) requires the accountant to withdraw from the engagement if the client refuses to provide additional or revised information. A scope restriction resulting from inadequate accounting records should normally be considered a client-imposed restriction. Although the restriction may be unintentional, the maintenance of adequate accounting records is within the client’s control. Situations where the client is unable to provide additional or revised information should be rare. One such situation may be when accounting records have been destroyed.

.71 When there has been a scope restriction that precludes a review report and the accountant decides to issue a compilation report, SSARS No. 1 (AR section 100.51) indicates he or she should issue an appropriate compilation report without any reference to the scope restriction.

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

Reporting on Financial Statements Included in MCS Reports

General

.73 Unaudited financial statements are often included in reports on findings in Management Consulting Services engagements (MCS reports). A question often arises as to what reporting responsibility the CPA has on those historical financial statements.

.74 Currently, there is no provision in SSARS to exempt historical financial statements included in MCS reports. Likewise, SSARS do not provide for different levels of service depending on the intended use of the financial statements. Consequently, SSARS currently require that only historical financial statements that the accountant submits to clients or others, including statements included in MCS reports, at least be compiled.

Financial Statements Compiled or Reviewed by Another Accountant

.75 If the MCS report contains financial statements that were compiled or reviewed by another accountant and the other accountant's report is included, the CPA is not required to mention the statements in the report. If, however, the other accountant's report is not included with the financial statements in the MCS report, the accountant should include a reference to the other accountant's report that includes:

- A statement describing the service performed by the other accountant, without disclosing that accountant's name
- The date of the other accountant's report
- A description of the standard disclaimer in a compilation report or, for a review, the standard limited assurance language included therein
- A description of any modifications of the standard compilation or review report, including any paragraphs that emphasize certain matters relating to the financial statements

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

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

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

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

Client-Prepared Financial Statements

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

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

Reporting When Only One Financial Statement Is Presented

.79 An accountant may issue a compilation report on a single financial statement, such as a balance sheet. Likewise, he or she may issue a review report on a single financial statement. Engagements to report on a single financial statement are limited reporting engagements, not scope restrictions.

Reporting on Comparative Financial Statements

.80 SSARS No. 2, *Reporting on Comparative Financial Statements* (AR section 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, the accountant may face some rather complex reporting decisions. Because the accountant may not face these complexities often, applying SSARS No. 2 can be daunting.

.81 The following definitions from SSARS No. 2 (AR section 200) may facilitate reporting on comparative financial statements.

- *Updated report*—A continuing accountant issues this kind of report, which considers new information from the current engagement and re-expresses the previous conclusions or expresses different conclusions on the prior-period financial statements as of the current report date.
- *Reissued report*—Issued subsequent to the date of the original report but bears the same date as the original report; a reissued report may need to be revised and dual-dated for the effects of specific events.

General

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

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

Practice Tip

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

Continuing Accountant's Standard Report

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

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

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

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

.87 If the second option is selected, the report may be

- A combined compilation and reissued review report. (The combined report should state that no review procedures were performed after the date of the review report.)
- Presented separately.

Continuing Accountant's Changed Reference to GAAP

.88 The accountant should consider the effects on the prior period report of circumstances or events that came to his or her attention. When the accountant's report contains a changed reference to a GAAP departure, the report should include a separate paragraph indicating

- Date of previous report.
- Circumstances or events that caused the change.
- If applicable, that the prior period financial statements have been changed.

Predecessor's Compilation or Review Report

.89 A predecessor accountant is not required to, but may choose to reissue his or her report. If the predecessor's compilation or review report is not presented, the successor should either

- Make reference to the predecessor's report.
- Perform a compilation, review, or audit of the prior period financial statements and report thereon.

.90 If "reference to the predecessor's report" option is selected, the successor's reference should include

- A statement that the prior period financial statements were compiled or reviewed by another accountant (without identifying the predecessor by name).
- The date of prior accountant's report.
- A description of the disclaimer or limited assurance report.
- A description or quotation of any report modification or emphasis paragraphs.

.91 If the predecessor report is to be reissued, before reissuing the predecessor should consider

- The current form and presentation of the prior period financial statements.
- Subsequent events not previously known.
- Changes in the financial statements that alter modifications to the report.

.92 The predecessor should also perform the following procedures:

- Read the current period financial statements and the successor's report.
- Compare the prior period financial statements (a) with those previously issued, and (b) with the current period.
- Obtain a letter from the successor indicating whether he or she is aware of any matter that affects the prior period financial statements.

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

- Make inquiries or perform analytical procedures similar to those that would have been applied to the information if it had been known at the report date.
- Perform other procedures considered necessary such as discussing the matter with the successor or reviewing the successor's working papers.

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

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

Changed Prior Period Financial Statements

.96 When the financial statements have been changed, either the predecessor (as discussed above) or the successor should report on the restated financial statements. If the successor reports on them, he or she should audit, review, or compile the financial statements and report accordingly. No references to the predecessor's report should be made in the successor's report.

Reporting When Prior Period Is Audited

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

- Reissue the audit report on the prior period or
- Add a separate paragraph to the current period report that includes the following information:
 - The financial statements of the prior period were audited.
 - The date of the audit report.
 - The type of opinion.
 - Substantive reasons for other than unqualified opinion.
 - No audit procedures were performed after the date of the audit report.

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

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

Change of Accountants—Reporting Following a Merger or Purchase of a Firm

.99 When there has been a merger or purchase of a firm, the new firm or purchaser should report as a successor accountant and apply the guidance in SSARS No. 2 (AR section 200). Basically, it permits the successor to (a) make reference to the old or acquired firm's report or (b) assume compilation, review, or audit responsibility for the prior period financial statements. The new firm or purchaser may also indicate in the report that a merger or purchase took place if reference is made to the predecessor's report. However, the predecessor firm should not be named.

Change of Accountants—Predecessor Accountant Has Ceased Operations

.100 A February 1991 *Notice to Practitioners* issued by the AICPA states that the reporting depends on whether the prior-period financial statements have been restated.

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

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

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

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

.103 If the prior-period financial statements have been restated, the successor accountant should compile, review or audit those financial statements and report accordingly.

Change of Status—Public/Nonpublic Entity

.104 A previously issued compilation or review report should not be reissued or referred to in the current report if the entity is currently a public entity.

SSARS No. 2 Summary

.105 SSARS No. 2 (AR section 200) is rather complex. The following summary decision aid helps simplify the report decision process in SSARS No. 2. The comparative statements are for years 20X5 and 20X6.

1. If 20X6 is audited, SASs apply.
2. If the entity's current status for 20X6 is a public company, SASs apply.

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

Split-Level Reporting

.106 Split-level reporting involves providing different levels of assurance on a single set of financial statements (for example, auditing the balance sheet and reviewing the income statement). Although the authoritative literature does not address this situation, most believe that it should be avoided.

Reporting When Other Accountants Have Audited or Reviewed a Component

.107 If other accountants are engaged to audit or review the financial statements of a division, branch, subsidiary, or other investee, the accountant should require reports from the other accountants as a basis, in part, for his report on his review of the financial statements of the reporting entity. The accountant may decide to refer to the work of the other accountants in his review report. If such a reference is made, the report should indicate the magnitude of the portion of the financial statements audited or reviewed by the other accountants. SSARS do not contain guidance for obtaining compilation reports from other accountants, since no assurance can be derived from compilation work.

Preliminary Financial Statement Drafts

.108 Interpretation No. 17 of SSARS No. 1 (AR section 9100.61) states that an accountant can submit draft financial statements without attaching a compilation or review report as long as:

- He or she intends to submit final financial statements, and
- He or she labels each page of the draft financial statements with words such as "Draft," "Preliminary Draft," "Draft—Subject to Change," or "Working Draft."

.109 In the rare circumstances where the accountant submits drafts but never issues the final statements, the interpretation suggests that the accountant document the reasons why. The interpretation reinforces the fact that preliminary drafts should not be used as a means of circumventing the reporting standards of SSARS.

[The next page is 2611.]

AAM Section 2610

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

.01 Accountants' Standard Report

Stockholders and Board of Directors
[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20XX, 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 (the owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X1

[Signature of CPA]

* APB Opinion No. 12, *Omnibus Opinion*—1967, requires the disclosure of a change in capital. This can be accomplished by the preparation of a separate statement, in the notes to the financial statements, or as part of another basic statement. If the accountant does not include a statement of retained earnings as a separate statement, reference in the compilation report is not needed.

.02 Omission of Substantially All Disclosures

Stockholders and Board of Directors
[*Company*]

I (We) have compiled the accompanying balance sheet of [*Company*] as of December 31, 20XX, 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 (the owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

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

January 28, 20X1

[*Signature of CPA*]

.03 Accountants Not Independent

Stockholders and Board of Directors

[*Company*]

[*Address*]

I (We) have compiled the accompanying balance sheet of [*Company*] as of December 31, 20XX, 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 (the owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

We are not independent with respect to [*Company*].

January 28, 20X1

[*Signature of CPA*]

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

Stockholders and Board of Directors
[*Company*]

I (We) have compiled the accompanying balance sheet of [*Company*] as of December 31, 20XX, 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 (the owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, I (we) did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

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

January 28, 20X1

[*Signature of CPA*]

.05 Departure From GAAP—Accounting Principles Not Generally Accepted

Stockholders and Board of Directors
[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20XX, 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 from generally accepted accounting principles that is described in the following paragraph.

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

January 28, 20X1

[Signature of CPA]

.06 Departure From GAAP—Accounting Principles Not Generally Accepted and Omission of Disclosures

Stockholders and Board of Directors
[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20XX, 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 (the owners). I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them. However, I (We) did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

Generally accepted accounting principles require that *[describe requirement]*. Management has informed me (us) that the company has *[describe departure]*, which is not in accordance with generally accepted accounting principles. Management has not determined the effect of the departure from generally accepted accounting principles on the accompanying balance sheet. The accompanying statements of income, retained earnings, and cash flows would not be affected by the departure.

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

January 28, 20X1

[Signature of CPA]

.07 Compilation Report—One Financial Statement

Stockholders and Board of Directors

[*Company*]

I (We) have compiled the accompanying balance sheet of [*Company*] as of December 31, 20X5, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

January 28, 20X6

[*Signature of CPA*]

.08 Continuing Accountants' Report on Comparative Statements—Both Periods Compiled

Stockholders and Board of Directors

[*Company*]

I (We) have compiled the accompanying balance sheets of [*Company*] as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the 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.

January 28, 20X3

[*Signature of CPA*]

.09 Continuing Accountants' Report on Comparative Statements—Current Period Compiled With Reference to Review Report on Prior Period

Stockholders and Board of Directors
[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of [Year] 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. 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 [Year] financial statements of [Company] were previously reviewed by us, and our report dated [Date] stated that 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 our report on the [Year] financial statements.

January 28, 20X6

[Signature of CPA]

.10 Continuing Accountants' Report on Comparative Statements—Both Periods Compiled With Restatement of Prior Period Financial Statements

Stockholders and Board of Directors
[Company]

I (We) have compiled the accompanying balance sheets of [Company] as of [Date] and [Date], 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. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

In my (our) previous compilation report dated [Date], on the [Year] financial statements, I (we) referred to a departure from generally accepted accounting principles because the company [describe departure]. However, as disclosed in Note [Number], the company has restated its [Year] financial statements to [describe correction] in accordance with generally accepted accounting principles.

January 28, 20X6

[Signature of CPA]

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

Stockholders and Board of Directors
[Company]

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

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

The [Year] financial statements of [Company] were compiled by other accountants whose report, dated [Date], stated that they did not express an opinion or any other form of assurance on those statements.

January 28, 20X6

[Signature of Successor CPA]

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

Stockholders and Board of Directors

[*Company*]

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

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

The [*Year*] financial statements of [*Company*] were reviewed by other accountants whose report, dated [*Date*], stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles.

January 28, 20X6

[*Signature of Successor CPA*]

.13 Continuing Accountants' Report on Comparative Statements—Current Period Compiled With Reference to Audit Report on Prior Period

Stockholders and Board of Directors
[Company]

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

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

The [Year] financial statements were audited by us and I (we) expressed an unqualified opinion on them in our report dated [Date]. I (We) have not performed any auditing procedures since that date.

January 28, 20X6

[Signature of CPA]

.14 Continuing Accountants' 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

Stockholders and Board of Directors

[*Company*]

I (We) have compiled the accompanying balance sheet of [*Company*] as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the 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 cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

The accompanying 20X1 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 reviewed as indicated in my (our) report dated March 1, 20X2.

January 28, 20X3

[*Signature of CPA*]

.15 Compilation Report—Financial Statements Accompanied by Supplementary Information

Stockholders and Board of Directors
[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X5, and the related statements of income, retained earnings, and cash flows for the year then ended, and the supplementary information appearing on pages [Numbers], which is presented only for supplementary analysis purposes, in accordance with Statements on Standards for Accounting and Review Services issued by the 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. I (We) have not audited or reviewed the accompanying financial statements and supplementary information and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X6

[Signature of CPA]

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

Stockholders and Board of Directors
[Company]

I (We) have compiled the accompanying balance sheet of [Company] as of December 31, 20X5, 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. I (We) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

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

January 28, 20X6

[Signature of CPA]

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

Stockholders and Board of Directors
[*Company*]

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

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

The [*Year*] financial statements of [*Company*] were reviewed by other accountants who have ceased operations and whose report, dated [*Date*], stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles.

January 28, 20X6

[*Signature of Successor CPA*]

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

Stockholders and Board of Directors

[*Company*]

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

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

The [*Year*] financial statements of [*Company*] were audited by other accountants who have ceased operations, and they expressed an unqualified opinion on them in their report dated [*Date*], but they have not performed any audit procedures since that date.

January 28, 20X6

[*Signature of Successor CPA*]

[*The next page is 2641.*]

AAM Section 2620

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

.01 Accountants' Standard Report

Stockholders and Board of Directors
[Company]

I (We) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X5, 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 [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 (we) are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

January 28, 20X6

[Signature of CPA]

* APB Opinion No. 12 requires the disclosure of a change in capital. This can be accomplished by the preparation of a separate statement, in the notes to the financial statements, or as part of another basic statement. If the accountant does not include a statement of retained earnings as a separate statement, reference in the review report is not needed.

.02 Departure From GAAP—Accounting Principle Not Generally Accepted

Stockholders and Board of Directors
[Company]

I (we) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X5, 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 [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 (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, investments in marketable equity securities should be reported at fair value. Management has informed us that the Company has stated these investments at cost, which is not in accordance with generally accepted accounting principles. If generally accepted accounting principles had been followed, the investment in marketable equity securities and stockholders' equity would have been decreased by \$70,000.

January 28, 20X6

[Signature of CPA]

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

Stockholders and Board of Directors

[*Company*]

I (we) have reviewed the accompanying balance sheet of [*Company*] as of December 31, 20X5, 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 of [*Company*].

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

Based on my (our) review, with the exception of the matter described in the following paragraph, I (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, 20X5, has not been presented. Generally accepted accounting principles require that such a statement be presented when financial statements purport to present financial position and results of operations.

January 28, 20X6

[*Signature of CPA*]

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

Stockholders and Board of Directors
[Company]

I (we) have reviewed the accompanying balance sheets of [Company] as of [Date] and [Date], 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 of [Company].

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

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

January 28, 20X6

[Signature of CPA]

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

Stockholders and Board of Directors

[*Company*]

I (we) have reviewed the accompanying balance sheet of [*Company*] as of [*Date*], and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of [*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 (we) are not aware of any material modifications that should be made to the accompanying [*Year*] financial statements in order for them to be in conformity with generally accepted accounting principles.

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

January 28, 20X6

[*Signature of CPA*]

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

Stockholders and Board of Directors

[*Company*]

I (we) have reviewed the accompanying balance sheets of [*Company*] as of [*Date*] and [*Date*], 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 of [*Company*].

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

Based on my (our) reviews, I (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 [*Date*], on the [*Year*] financial statements, I (we) referred to a departure from generally accepted accounting principles because the company [*describe departure*]. As discussed in Note [*Number*], however, the company has restated its [*Year*] financial statements to [*describe correction*] in accordance with generally accepted accounting principles.

January 28, 20X6

[*Signature of CPA*]

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

Stockholders and Board of Directors

[*Company*]

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

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

Based on my (our) review, I (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 [*Year*] financial statements of [*Company*] were reviewed by other accountants whose report, dated [*Date*], stated that they were not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

January 28, 20X6

[*Signature of Successor CPA*]

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

Stockholders and Board of Directors
[Company]

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

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

Based on my (our) review, I (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 [Year] financial statements of [Company] were compiled by other accountants whose report, dated [Date], stated that they did not express an opinion or any other form of assurance on those statements.

January 28, 20X6

[Signature of Successor CPA]

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

Stockholders and Board of Directors
[Company]

I (we) have reviewed the accompanying balance sheet of [Company] as of [Date], and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of [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 (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 [Year] financial statements were audited by us, and I (we) expressed an unqualified opinion on them in our report dated [Date]. I (we) have not performed any auditing procedures since that date.

January 28, 20X6

[Signature of CPA]

.10 Review Report—Supplementary Information Subjected to Review Procedures

Stockholders and Board of Directors

[*Company*]

I (we) have reviewed the accompanying balance sheet of [*Company*] as of December 31, 20X5, 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 [*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 (we) are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

My (our) review was made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. The supplementary data appearing on pages [*Numbers*] are presented only for supplementary analysis purposes. This supplementary information has been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, and I (we) are not aware of any material modifications that should be made thereto.

January 28, 20X6

[*Signature of CPA*]

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

Stockholders and Board of Directors

[*Company*]

I (we) have reviewed the accompanying balance sheet of [*Company*] for the year ended December 31, 20X5, 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 [*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 (we) are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

My (Our) review was made for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles. The accompanying information included on pages [*Numbers*] is not a required part of the basic financial statements but is supplementary information presented by the Company. Such information is presented only for analysis purposes and has not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements. This information was compiled from information that is the representation of management, without audit or review. Accordingly, I (we) do not express an opinion or any other form of assurance on these data.

January 28, 20X6

[*Signature of CPA*]

.12 Review Report—Emphasis of a Going Concern Uncertainty

Stockholders and Board of Directors

[*Company*]

I (we) have reviewed the accompanying balance sheet of [*Company*] as of December 31, 20X5, 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 [*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 (we) are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

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

January 28, 20X6

[*Signature of CPA*]

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

Stockholders and Board of Directors
[Company]

I (we) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X5, 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 [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 (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, 20X4, were reviewed by other accountants who have ceased operations and whose report, dated [Date], stated that they were not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles.

January 28, 20X6

[Signature of CPA]

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

Stockholders and Board of Directors
[Company]

I (we) have reviewed the accompanying balance sheet of [Company] as of December 31, 20X5, 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 [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 (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, 20X4, were audited by other accountants who have ceased operations, and they expressed an unqualified opinion on them in their report dated March 1, 20X5, but they have not performed any auditing procedures since that date.

January 28, 20X6

[Signature of CPA]

[The next page is 2661.]

AAM Section 2700

Special Areas

Other Comprehensive Bases of Accounting

.01 Bases of accounting other than GAAP (referred to as “Other Comprehensive Bases of Accounting,” or OCBOA) have become a widely used alternative to the numerous and sometimes complex accounting requirements prescribed by GAAP. Unfortunately, there is very little authoritative guidance related to applying OCBOA.

.02 The only authoritative guidance for OCBOA is found in the auditing standards. SAS No. 62, *Special Reports* (AU section 623.03) and states that “an independent auditor’s judgment concerning the overall presentation of financial statements should be applied within an identifiable framework.” Ordinarily, that framework is provided by GAAP, but SAS No. 62 allows the use of a comprehensive basis of accounting other than GAAP (SSARS No. 1 [AR section 100] also recognizes OCBOA for compiled and reviewed financial statements). SAS No. 62 recognizes the following OCBOAs:

- The basis of accounting the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency which has jurisdiction over the entity
- The basis of accounting the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements
- The cash receipts and disbursements basis of accounting, and modifications of the cash basis having substantial support, such as recording depreciation on fixed assets or accruing income taxes
- A definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting

.03 SAS No. 62 (AU section 623.04) prohibits auditors from issuing the special report described in the SAS unless one of the foregoing descriptions applies to the financial statements.

Deciding When To Use an OCBOA

.04 OCBOA financial statements are beneficial to clients for many reasons. Among them is the idea that accountants do not need to consider the measurement requirements of GAAP for OCBOA financial statements and, therefore, OCBOA statements often can be prepared on a more timely and cost efficient basis.

.05 You might consider the following characteristics of entities as good candidates for cash- or tax-basis financial statements:¹

- There are no third-party users of financial statements (e.g., the entity is closely held with no third-party debt)
- The entity’s debt is secured rather than unsecured
- The entity’s creditors do not require GAAP financial statements
- The cost of complying with GAAP would exceed the benefits

¹ Source: AICPA, *Compilation and Review Alert* (1996/1997).

- The owners and managers are closely involved in the day-to-day operations of the business and have a fairly accurate picture of the entity's financial position
- The business's owners are primarily interested in cash flows
- The owners are primarily interested in the tax implications of transactions
- Capital expenditures and long-term financing are not significant
- Internal Revenue Code rules do not require the entity to prepare its tax return on the accrual basis

.06 In advising clients about the use of an OCBOA, accountants should consider the following issues:

- Does the entity have inventory? If so, the pure cash basis may not be helpful.
- What basis of accounting does the entity use in preparing its income tax return? If the accrual basis is used, preparing financial statements on the same basis makes sense.
- Is the entity highly leveraged? Lenders may require GAAP financial statements.
- Are there outside investors? GAAP financial statements may provide information required by such users.
- Does the entity's cash flow parallel its income and expenses? The pure cash basis may be appropriate.
- Does the entity anticipate going public? If so, the entity will need a history of GAAP financial statements.
- Was the entity formed for tax purposes? If yes, the owners are probably interested in the tax effects of transactions, and the income tax basis would be appropriate.
- Is the entity subject to bonding requirements? Most bonding companies will only accept GAAP financial statements.

Basic Financial Statements

.07 In an OCBOA presentation, the basic financial statements typically present financial position and results of operations as measured under the OCBOA, descriptions of accounting policies, and notes to the financial statements. However, an exception to this presentation exists for entities that use the pure cash basis of accounting. Under the pure cash basis of accounting, a statement of assets, liabilities, and equity would be needless because the cash balance would be the only item that would appear. Consequently, entities using the pure cash basis of accounting present a single statement titled "Statement of Cash Receipts and Disbursements."

Statement Titles

.08 SAS No. 62 (AU section 623.07) and Interpretation No. 12 of SSARS No. 1 (AR section 9100.41–.43) indicate that titles of OCBOA financial statements should differ from titles of similar statements prepared in accordance with GAAP. SAS No. 62 (AU section 623) and Interpretation No. 12 do not require specific titles, although they do list examples.

Table 2700.1**Suggested OCBOA Statement Titles**

<i>GAAP</i>	<i>Cash-Basis</i>	<i>Tax-Basis</i>
Balance Sheet	Statement of Assets, Liabilities, and Equity—Cash Basis	Statement of Assets, Liabilities, and Equity—Income Tax Basis
Statement of Income	Statement of Revenues and Expenses—Cash Basis	Statement of Revenues and Expenses—Income Tax Basis
Statement of Income & Retained Earnings	Statement of Revenues, Expenses, and Retained Earnings—Cash Basis	Statement of Revenues, Expenses, and Retained Earnings—Income Tax Basis
Statement of Changes in Equity	Statement of Changes in Equity—Cash Basis	Statement of Changes in Equity—Income Tax Basis
Statement of Cash Flows	Statement of Cash Flows—Cash Basis	Statement of Cash Flows—Income Tax Basis

Notes:

- These titles are only suggestions. Other titles may be derived from the suggestions in SAS No. 62 (AU section 623.07).
- The pure cash basis has a single asset and no liabilities. Accordingly, only a single statement titled “Statement of Cash Receipts and Disbursements” is normally presented.
- Although Financial Accounting Standards Board (FASB) Statement No. 95, *Statement of Cash Flows*, does not require a statement of cash flows for OCBOA financial statements, if a cash flow statement is presented, it is suggested that the basis of accounting used be added to the statement title.

Disclosures

.09 Authoritative accounting literature does not address OCBOA or the disclosures necessary in such presentations. Limited guidance on disclosures can be found in the auditing literature (which is also applicable to compilation and review engagements). SAS No. 62 (AU section 623) establishes the overriding criterion that cash, modified cash, and income tax basis financial statements should be “informative of matters that may affect their use, understanding, and interpretation.” It goes on by stating that:

- The financial statements should include a summary of significant accounting policies that discusses the basis of presentation and describes how the basis differs from GAAP
- When financial statements contain items the same as, or similar to, those in GAAP financial statements, similar disclosures are appropriate (e.g., depreciation or long-term debt)
- The auditor should also consider disclosing matters not specifically identified on the face of the statements, such as related party transactions, restrictions on assets and owners’ equity, subsequent events, and uncertainties.

.10 Nevertheless, diversity in practice has developed over the years. Accountants at one extreme believe disclosures should be included in cash, modified cash, and income tax basis financial statements that are identical to those that would be included in a GAAP presentation. Accountants at the other extreme would recommend including very little disclosure in OCBOA statements.

.11 A survey completed by the AICPA Private Companies Practice Section in the mid-1990's found that there was a great deal of diversity in the interpretation of SAS No. 62 (AU section 623) regarding the issue of disclosures. Guidance for practitioners was needed.

.12 To help clarify the issue of the disclosures related to SAS No. 62, the Audit Issues Task Force (AITF) of the Auditing Standards Board issued Interpretation No. 14 of SAS No. 62, *Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting* (AU section 9623.90–.95). The Interpretation provides the following guidance:

- The discussion of the basis of accounting required by SAS No. 62 (AU section 623) may be brief and only needs to describe the primary differences from GAAP. Quantifying differences is not required.
- If the financial statements contain amounts for which GAAP would require disclosure, the statements should either provide the relevant disclosure or provide information that communicates the substance of that disclosure.
- If GAAP sets forth requirements that apply to the presentation of financial statements, cash, modified cash, and income tax basis statements should either comply with those requirements or provide information that communicates the substance of those requirements.
- A statement of cash flows is not required in presentations on the cash, modified cash, or income tax basis of accounting. However, if a presentation of cash receipts and disbursements is presented in a format similar to a statement of cash flows or if the entity chooses to present such a statement, the statement should conform to the requirements for a GAAP presentation or communicate the substance of the GAAP requirements.
- If GAAP would require disclosure of other matters, the need for that same disclosure or disclosure that communicates the substance of those requirements should be considered.

Cash Basis of Accounting

Pure Cash Basis

.13 Under the cash receipts and disbursements basis of accounting ("pure cash basis"), only transactions that increase or decrease cash and cash equivalents are reflected in the financial statement. The pure cash basis recognizes all cash disbursements as expenses and all cash receipts as revenues. In practice, the pure cash basis of accounting is rare.

.14 Entities that use the pure cash basis of accounting would include, for example, school activity funds, civic ventures, trusts and estates, political action committees and political campaigns. Typically, those types of entities have the following characteristics:

- They are not-for-profit oriented
- Their operations are simple
- Their accounting and finance functions are unsophisticated
- There is only one major activity
- Capital expenditures and long-term debt are not significant

Modified Cash Basis

.15 SAS No. 62 (AU section 623) describes the modified cash basis of accounting as the pure cash basis incorporating modifications having substantial support. These modifications generally include the recognition

of certain transactions on an accrual basis, as entities would recognize them under GAAP. The appropriate modifications and the extent of those modifications are not clearly defined in the literature, however.

.16 Generally, entities that use the modified cash basis of accounting, such as professional association of doctors, lawyers, or CPAs, might include the following characteristics:

- They are profit oriented
- They distribute profits as collected (e.g., through bonuses and retirement plan contributions)
- They have significant inventory and credit arrangements with vendors
- They make material capital expenditures or incur material amounts of debt
- Their operations are somewhat sophisticated, and accounting for them may become complex

Income Tax Basis of Accounting

.17 The income tax basis of accounting typically is based on federal income tax laws that generally do not address financial statement presentation or disclosure considerations, however.

.18 Typically, entities that use the tax basis of accounting are either:

- Profit oriented enterprises (such as small, closely held companies for which conversion to GAAP would be costly)
- Partnerships whose partnership agreements require the use of the tax basis of accounting
- Not-for-profit organizations seeking relief from the requirements of FASB Statement Nos. 116, *Accounting for Contributions Received and Contributions Made*, and 117, *Financial Statements of Not-for-Profit Organizations*.

Nontaxed Entities

.19 SAS No. 62 (AU section 623.04) defines the income tax basis of accounting as the basis an entity uses or expects to use to file its income tax return. However, SAS No. 62 does not provide any additional guidance on what is meant by the phrase "income tax return." If taken literally, many entities would not be able to use the income tax basis under SAS No. 62 (AU section 623). Interpretation No. 14 of SAS No. 62 includes examples of not-for-profit organizations using the accounting principles followed in filing Form 990, thus acknowledging that such entities may issue income tax basis financial statements.

Other Bases of Accounting

.20 Although less common, entities may present their financial statements on a basis of accounting other than cash, tax, or GAAP. For example, insurance companies present financial statements on a regulatory basis. In addition, SAS No. 62 (AU section 623) allows entities to use other comprehensive bases if they have substantial support and are applied consistently to all items in the financial statements. At the present time, however, only the price-level basis of accounting meets that criteria, and its use is very rare.

Disclosure of Basis of Accounting

.21 SSARS No. 1 states that when the accountant reports on compiled financial statements that omit substantially all disclosures, he or she must disclose the basis of accounting in the compilation report if it is not disclosed in the financial statements. This paragraph has been interpreted by some accountants to mean that compiled or reviewed OCBOA financial statements must disclose the OCBOA in some manner, but that such statements are not required to describe the basis of accounting or to state that it is a comprehensive

basis of accounting other than GAAP. SAS No. 62 (AU section 623) requires these latter two disclosures for audited OCBOA financial statements.

.22 Interpretation No. 12 of SSARS No. 1 (AR section 9100.41–.43) clarifies the disclosure requirements of OCBOA financial statements. The interpretation states that, ordinarily, OCBOA statements would contain a note stating the basis of presentation and describing how the basis differs from GAAP. Thus, the interpretation implies that the OCBOA disclosures for a SSARS engagement and an audit engagement should be similar. However, the location of this disclosure does differ. In a SSARS engagement, the disclosure is made in the notes. In an audit engagement, SAS No. 62 (AU section 623) requires that the disclosure of the basis of presentation and a statement that it is a basis other than GAAP be made in a separate paragraph in the auditor's report, with a description of how the basis of presentation differs from GAAP in the notes. However, the difference between GAAP and the basis need not be quantified. Interpretation No. 12 of SAS No. 62 makes an exception to this disclosure requirement for compiled OCBOA financial statements that omit substantially all disclosures. In such an engagement, the report is modified by adding a sentence such as the following to the first paragraph of the report:

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.

.23 In summary, compiled OCBOA financial statements should ordinarily contain a note that discloses the basis of presentation and describes how it differs from GAAP (This disclosure must always be made in reviewed financial statements. Otherwise, the review report would have to be modified for an OCBOA disclosure exception.) If this disclosure is included in the notes, only the financial statement titles should be modified in the report. If all disclosures are omitted from compiled financial statements, the compilation report should be modified as illustrated above.

Other Disclosures

.24 Financial statements prepared on an OCBOA require notes and other disclosures. If the statements are compiled, management may elect to omit substantially all disclosures. However, this option is not available if the statements are reviewed.

Reporting

.25 In general, the only report modification necessary when financial statements are prepared using a comprehensive basis of accounting other than GAAP is the identification of the financial statements. Since financial statements prepared using an OCBOA must contain modified titles (e.g., "Statement of Assets, Liabilities, and Equity—Income Tax Basis" instead of "Balance Sheet"), the compilation or review report should refer to the modified titles actually used on the statements (e.g., "We have compiled the accompanying statement of assets, liabilities, and equity—income tax basis . . .") However, when the accountant compiles OCBOA financial statements that omit substantially all disclosures, SSARS No. 1 (AR section 100) requires that he or she disclose the basis of accounting. This disclosure may be in an attached footnote or in a note on the face of the financial statements. If disclosure is not made as part of the financial statements, modification of the compilation report would be required.

.26 In addition, if substantially all disclosures have been omitted, the accountant must communicate this fact in the compilation report, by adding the following paragraph:

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

Prescribed Forms

Background

.27 One of the major complications of prescribed form engagements has been the requirement in SSARS No. 1 (AR section 100) that the accountant's report disclose all material measurement departures from GAAP. In 1981, the ARSC issued SSARS No. 3 (AR section 300), which amends SSARS No. 1 and SSARS No. 2 (AR section 200) to provide for an alternative form of standard compilation report when the prescribed form or related instructions call for departures from GAAP.

Provisions of SSARS No. 3

.28 Any standard preprinted form designed or adopted by the body to which it is to be submitted is a prescribed form. Examples include forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities.

.29 According to SSARS No. 3 (AR section 300.03), the following alternative form of compilation report is appropriate when the financial statements are included in a prescribed form that calls for a departure from GAAP:

I (We) have compiled the (identification of financial statements, including period covered and name of entity) included in the accompanying prescribed form in accordance with Statements on Standards for Accounting and Review Services issued by the 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 management (the owners). I (We) have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

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

.30 Note that the first two paragraphs are similar to the standard compilation report of SSARS No. 1 (AR section 100). The main differences are the references to:

- The prescribed form
- The body that prescribed the form
- The third paragraph, which indicates that the basis of accounting and disclosures required by the form are different from GAAP and cautions the reader about the limits of the financial statements.

Departures From GAAP or From the Prescribed Form

.31 The accountant is concerned with three types of departures in an engagement to compile financial statements to be included in a prescribed form:

- Departures from GAAP required by the prescribed form. This type of departure does not require disclosure in the SSARS No. 3 report.
- Departures from GAAP not required by the prescribed form. Such departures must be disclosed following the guidance in SSARS No. 1 (AR section 100).

- Departures from the requirements of the prescribed form. These departures also require disclosure following the guidance in SSARS No. 1.

.32 For the items in the second and third bullets in the preceding paragraph, the accountant must modify the compilation report to identify, in a separate paragraph the departures, including the effects, if known. If not known, the accountant must include a statement that the effects have not been determined.

Signing a Preprinted Report Form

.33 SSARS No. 3 (AR section 300.05) states that the accountant should not sign a preprinted report form unless the language in it conforms to the guidance in SSARS No. 3 (AR section 300) or SSARS No. 1 (AR section 100). If the preprinted report is not suitable, the accountant should attach an appropriate report to the prescribed form. It is advisable to type, "See accountant's report" in the prescribed form signature block.

Determining When SSARS No. 3 Is Applicable

.34 Questions involving the applicability of SSARS No. 3 (AR section 300) might pertain to the definition of a prescribed form, the type of service involved or clarification of how a form calls for a departure from GAAP. These issues are discussed in the following questions.

.35 Does SSARS No. 3 (AR section 300) establish different standards for compiling a prescribed form? No. The reporting standards of SSARS No. 1 (AR section 100) require issuing a report whenever the accountant compiles or reviews financial statements included in a prescribed form. SSARS No. 3 (AR section 300) merely provides an alternative form of standard compilation report. It does not expand the accountant's reporting responsibility, nor does it change the performance standards of SSARS No. 1.

.36 Is SSARS No. 3 (AR section 300) applicable to review engagements? No. SSARS No. 3 (AR section 300) makes no provision for an alternative review report. A review report must conform to the standards of SSARS No. 1 (AR section 100) or SSARS No. 2 (AR section 200). The report must describe any departures from GAAP (even if the departures are called for by the form). The review report must also describe each GAAP disclosure that is omitted.

.37 Is a tax return a prescribed form? No. SSARS No. 3 (AR section 300) refers to financial statements, and thus excludes financial presentations included in tax returns. Interpretation No. 10 of SSARS No. 1 (AR section 9100.31) points out that an accountant may attach a report to tax or information returns. This report should follow the guidance in SSARS No. 1 (AR section 100), since the tax return will be submitted to a user that did not design the form.

.38 Does a comprehensive set of instructions constitute a prescribed form? No. The definition of a prescribed form in SSARS No. 3 (AR section 300) specifically includes the words "standard preprinted form."

.39 Is SSARS No. 3 (AR section 300) applicable to a prescribed form that does not call for departures from GAAP? No. If the form does not call for departures from GAAP, the SSARS No. 3 alternative report is not appropriate.

.40 How does a prescribed form call for departures from GAAP? SSARS No. 3 (AR section 300) indicates that a form calls for a departure from GAAP by either:

- Specifying a measurement principle not in conformity with GAAP; or
- Failing to request disclosures required by GAAP

.41 Can a SSARS No. 1 (AR section 100) report be issued even if SSARS No. 3 (AR section 300) applies? Yes. The accountant must, however, comply with SSARS No. 1 regarding departures from GAAP.

.42 Is the SSARS No. 3 (AR section 300) report appropriate when a prescribed form is presented to other third parties? No. The SSARS No. 3 (AR section 300) alternative report presumes that the information required by a prescribed form is sufficient to meet the needs of the body that designed or adopted the form.

.43 What does a CPA do when financial statements presented on an OCBOA are included in the prescribed form and uses the terms "Balance Sheet," "Income Statement," etc.? In practice, the titles usually are not changed, and the report on the statements use the preprinted titles.

.44 What if the CPA is not independent? An accountant who is not independent can issue a SSARS No. 3 (AR section 300) report on financial statements included in a prescribed form. He or she must, however, comply with SSARS No. 1 (AR section 100) and include the following as the last paragraph of the report:

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

.45 Does the CPA have to mark each page of the prescribed form with "See Accountant's Report"? Yes. SSARS No. 3 (AR section 300) does not change that requirement.

Personal Financial Statements

.46 The term "personal financial statements" refers to financial statements that present the personal assets and liabilities of an individual or group of related individuals.

.47 AICPA Statement of Position (SOP) 82-1, *Accounting and Financial Reporting for Personal Financial Statements*, is the principle source of guidance in dealing with personal financial statements. This SOP establishes the current value basis of accounting as GAAP for personal financial statements. The AICPA's *Personal Financial Statement Guide*, contains guidance on the scope of work and form of report for audits, reviews, and compilations of personal financial statements.

Personal Financial Statements Engagements

.48 Using the estimated current value basis of accounting in personal financial statements creates some unique considerations for accountants engaged to compile or review such statements.

Acceptance of Clients

.49 Before accepting the engagement, the accountant should consider his independence, the client's integrity, and circumstances that present unusual business risks.

.50 Personal financial statement engagements usually require a greater degree of client participation than do other engagements. In many cases, client interviews and telephone inquiries are an integral part of the process. Therefore, it is especially important to consider a potential client's ability and willingness to provide sufficient data and reliable estimates of current value.

Engagement Letters

.51 Both SSARS No. 1 (AR section 100) and the *Personal Financial Statements Guide* recommend, but do not require, written engagement letters. Engagement letters are especially important in personal financial statement engagements to:

- Dispel any notion that the accountant is responsible for estimates of current value
- Link the client's cooperation to the fee, since the cooperation of the client is vital to developing adequate accounting information

Client Representation Letters

.52 Although SSARS No. 1 (AR section 100) only requires that a representation letter be obtained from the client in engagements to review personal financial statements, the *Personal Financial Statements Guide* recommends obtaining written representations on all personal financial statement engagements, because:

- The informal nature of personal financial records usually requires that accountants place greater reliance on the client's representation to ensure completeness of the statements
- The estimated current values and amounts of assets and liabilities provided by the client have a significant effect on the statements
- A client representation letter can help to clarify that responsibility for the estimates of current value, even if developed by the accountant, rests with the client.

Compilation of Personal Financial Statements

.53 Standards for compilation of financial statements prescribed by SSARS No. 1 (AR section 100) are applicable to the compilation of personal financial statements in the same manner as to the compilation of other financial statements. (There is an exception for personal financial statements contained in written financial plans, if certain criteria are met (see the subsequent section in this Manual, "Exception for Personal Financial Statements Included in Written Financial Plans"). Thus, in compiling personal financial statements, the accountant must meet the same general requirements.

.54 First, the accountant should have knowledge of the accounting principles and practices applicable to personal financial statements. For instance, the accountant should understand the provisions of SOP 82-1.

.55 Second, the accountant should possess a general understanding of:

- The nature of the individual's transactions
- The form of available accounting records
- The stated qualifications of accounting personnel, if any
- The basis of accounting on which the financial statements are to be presented
- The form and content of the financial statements
- The methods used for determining estimated current values of significant assets and estimated current amounts of significant liabilities, and be able to consider whether the methods are appropriate in light of the nature of each asset or liability

.56 Third, the accountant should read the financial statements and consider whether they appear to be appropriate in form and free of obvious material errors.

.57 The standards prescribed by SSARS do not require an accountant to verify the reasonableness of information supplied to him or her in a compilation engagement. Accordingly, he or she can compile personal financial statements based on the client's estimate of current values and amounts.

.58 However, the *Personal Financial Statements Guide* warns that other factors may prevent the acceptance of the client's estimate. The Guide requires that, at a minimum, the accountant obtain an understanding of the methods by which the individual determined the estimated current values and amounts and consider whether the methods are appropriate for the asset or liability.

.59 With the exception of compiled personal financial statements that omit substantially all disclosures, the financial statements, including the notes, should disclose the method used to determine the estimated current values and amounts, even when such values or amounts are based on the individual's estimate.

.60 In many situations, particularly when the individual is unsophisticated in financial matters, the individual and the accountant will jointly develop the estimated current values and amounts. In such situations, the accountant should obtain the individual's approval and acceptance of responsibility for the values, preferably in writing.

Review of Personal Financial Statements

.61 Standards for the review of financial statements prescribed by SSARS No. 1 (AR section 100) are applicable to the review of personal financial statements in the same manner as the review of other financial statements. Accordingly, to review personal financial statements, the accountant must meet the following general requirements.

.62 The accountant should possess (a) a level of knowledge of the accounting principles and practices applicable to personal financial statements and (b) an understanding of the individual's financial activities and financial position that will provide him, through the performance of inquiry and analytical procedures, with a reasonable basis for expressing limited assurance that no material modifications are necessary to the financial statements for them to conform to GAAP. Knowledge of accounting principles and practices implies that the accountant should be thoroughly familiar with the requirements of SOP 82-1.

.63 SSARS No. 1 (AR section 100) requires accountants to obtain a representation letter in all review engagements.

Reporting

.64 In general, the only report modifications necessary when presenting personal financial statements are the identification of the financial statements and identification of the reporting entity. For example:

I (we) have compiled the accompanying statement of financial condition of James and Jane Person as of December 31, 20XX, and the related statement of changes in net worth for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the 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.

.65 However, when the accountant compiles personal financial statements that omit substantially all disclosures, the *Personal Financial Statements Guide* requires that he or she disclose that assets are presented at their estimated current values and liabilities are presented at their estimated current amount. This disclosure may be in an attached footnote or in a note on the face of the financial statements. If disclosure is not made as part of the financial statements, modification of the compilation report would be required. For example, the following sentence could be added to the first paragraph of the standard compilation report:

The financial statement(s) is (are) intended to present the assets of James and Jane Person at estimated current values and their liabilities at estimated current amounts.

.66 In addition, if substantially all disclosures have been omitted, the accountant must communicate this fact in the compilation report, by adding the following paragraph:

The individuals whose financial statements are presented have elected to omit substantially all disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the individuals' assets, liabilities, and net worth. Accordingly, these financial statements are not designed for those who are not informed about such matters.

Exception for Personal Financial Statements Included in Written Financial Plans

.67 SSARS No. 6 (AR section 600.03) provides an exemption from SSARS No. 1 (AR section 100) for personal financial statements included in written personal financial plans when the following conditions exist:

- The accountant establishes an understanding with the client, preferably in writing, that the financial statements (1) will be used solely to assist the client and the client's advisers to develop the client's personal financial goals and objectives and (2) will not be used to obtain credit or for any purpose other than developing the financial plan
- Nothing comes to the accountant's attention during the engagement that would cause him to believe that the financial statements will be used to obtain credit or for any purpose other than developing the client's financial goals and objectives

.68 If both conditions exist, the accountant is exempt from both the performance and reporting standards in SSARS No. 1 (AR section 100). Absent both of these conditions, SSARS No. 1 would apply.

.69 As long as those same conditions are met, Interpretation No. 1 of SSARS No. 6 (AR section 9600.01) clarifies that the same exception applies when an accountant submits a written personal financial plan containing the financial statements for use by a client's advisers to help the client implement the personal financial plan. Implementing the plan includes, for example, use of the plan by an insurance broker who will recommend specific insurance products to the client, an investment adviser who will provide specific recommendations about the investment portfolio, and an attorney who will draft a will or trust document.

The Accountant's Report

.70 SSARS No. 6 (AR section 600) prescribes the following language when the conditions of the SSARS No. 1 (AR section 100) exemption are met:

The accompanying statement of financial condition of John Doe, as of December 31, 20XX, was prepared solely to help you develop your personal financial plan. Accordingly, it may be incomplete or contain departures from generally accepted accounting principles and should not be used to obtain credit or for any other purposes other than developing your personal financial plan. We have not audited, reviewed, or compiled the statement.

.71 SSARS No. 6 (AR section 600) does not require the accountant to identify specific measurement or disclosure departures in the report. As with any SSARS engagement, the accountant is required to place a notation such as "See accountant's report" on each financial statement page.

Specified Elements, Accounts, or Items of a Financial Statement

.72 Authoritative guidance for reporting on specified elements, accounts, or items of a financial statement is contained in SAS No. 62, *Special Reports* (AU section 623), SSAE No. 10, chapter 1, *Attest Engagements* (AT section 101), and Interpretation No. 8 of SSARS No. 1 (AR section 9100.27-.28). According to SAS No. 62 (AU

section 623) and Interpretation No. 8, an accountant can audit or apply agreed-upon procedures to a specified element, account or item of a financial statement that is presented separately, i.e., not presented as supplementary information with financial statements. In addition, Interpretation No. 8 allows the accountant to review such information under the Attestation Standards.

.73 In addition to the above alternatives, most believe that an accountant can issue a compilation report on a presentation of a specified element, account or item of a financial statement. However, the accountant's report should not refer to "Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants" in the first paragraph, since such standards do not exist (applicable to specified elements, accounts or items of a financial statement).

.74 An accountant may also review or compile a specified element that is presented as supplementary information to the basic financial statements and report on it in accordance with SSARS No. 1 (AR section 100).

.75 The following table summarizes the reporting responsibilities for specified elements, accounts, or items of a financial statement.

<i>Assurance Level</i>	<i>Element Presented Separately</i>	<i>Element Presented as Supplement to Financial Statements</i>
Audit	May audit under SAS No. 62	May audit under SAS No. 29
Review	Review under SSAE No. 10, chapter 1, <i>Attest Engagements</i>	May review under SSARS No. 1
Compilation	Not addressed in authoritative literature, but most believe that compilation is permissible. Report should not refer to SSARS.	May compile under SSARS No. 1
Agreed-Upon Procedures	Apply agreed-upon procedures under SSAE No. 10, chapter 2, <i>Agreed-Upon Procedures Engagements</i>	Not applicable

Relationship of Statements on Standards for Accounting and Review Services to Quality Control Standards

.76 SSARS No. 1, as amended by SSARS No. 9 (AR section 100.53–.55), states that an accountant is responsible for compliance with Statements on Standards for Accounting and Review Services (SSARSs) in a review or compilation engagement. Rule 202 [ET section 202.01] of the Code of Professional Conduct of the American Institute of Certified Public Accountants requires members to comply with such standards when associated with reviewed or compiled financial statements.

.77 An accountant has the responsibility to adopt a system of quality control in conducting an accounting practice. Thus, a firm should establish quality control policies and procedures to provide it with reasonable assurance that its personnel comply with SSARS in its review and compilation engagements. The nature and extent of a firm's quality control policies and procedures depend on factors such as its size, the degree of operating autonomy allowed its personnel and its practice offices, the nature of its practice, its organization, and appropriate cost-benefit considerations.

.78 SSARSs relate to the conduct on individual review and compilation engagements; Statements on Quality Control Standards (SQCSs) relate to the conduct of a firm's accounting practice. Thus, SSARSs and

SQCSs are related, and the quality control policies and procedures that a firm adopts may affect both the conduct of an individual engagement and the firm's accounting practice as a whole. However, deficiencies in or instances of noncompliance with a firm's quality control policies and procedures do not, in and of themselves, indicate that a particular review or compilation engagement was not performed in accordance with SSARs. This amendment is effective for review reports dated January 1, 2003, or after, by Statement on Standards for Accounting and Review Services No. 9.

[The next page is 2701.]

AAM Section 2710

Accountants' Reports on Prescribed Forms, Specified Elements, Personal Financial Statements, and OCBOA Financial Statements

.01 Compilation Report—Cash Basis Statements; Full Disclosure

Stockholders and Board of Directors
[*Company*]

We have compiled the accompanying statement of assets, liabilities, and equity—modified cash basis of [*Company*] as of [*Date*], and the related statement of revenues and expenses—modified cash basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the 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. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X6

[*Signature of CPA*]

.02 Compilation Report—Cash Basis Statements; Omission of Substantially All Disclosures, With No Reference to Basis

Stockholders and Board of Directors

[*Company*]

[*Address*]

We have compiled the accompanying statement of assets, liabilities, and equity—modified cash basis of [*Company*] as of [*Date*], and the related statement of revenues and expenses—modified cash basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The financial statements have been prepared on the modified cash basis of accounting, which is a comprehensive basis of accounting other than generally accepted accounting principles.

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

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

January 28, 20X6

[*Signature of CPA*]

.03 Compilation Report—Tax Basis Statements; Full Disclosure

Stockholders and Board of Directors

[*Company*]

[*Address*]

We have compiled the accompanying statement of assets, liabilities, and equity—income tax basis of [*Company*] as of [*Date*], and the related statement of revenues and expenses—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the 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. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X6

[*Signature of CPA*]

.04 Compilation Report—Tax Basis Statements; Omission of Substantially All Disclosures, With No Reference to Basis

Stockholders and Board of Directors

[Company]

[Address]

We have compiled the accompanying statement of assets, liabilities, and equity—income tax basis of [Company] as of [Date], and the related statement of revenues and expenses—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The financial statements have been prepared on the income tax 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. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

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

January 28, 20X6

[Signature of CPA]

.05 Review Report—Cash Basis Statements; Full Disclosure

Stockholders and Board of Directors

[*Company*]

[*Address*]

We have reviewed the accompanying statement of assets, liabilities, and equity—cash basis of [*Company*] as of [*Date*], and the related statement of cash receipts and disbursements for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of [*Company*].

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

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

January 28, 20X6

[*Signature of CPA*]

.06 Review Report—Tax Basis Statements; Full Disclosure

Stockholders and Board of Directors

[*Company*]

[*Address*]

We have reviewed the accompanying statement of assets, liabilities, and equity—income tax basis of [*Company*] as of [*Date*], and the related statement of revenues and expenses—income tax basis for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of [*Company*].

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

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

January 28, 20X6

[*Signature of CPA*]

.07 Financial Statements Included in Certain Prescribed Forms

[Name], President

[Company]

[Address]

We have compiled the accompanying balance sheet of [Company] as of [Date], 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 the [Name of Bank or Other Entity] information that is the representation of management. We have not audited or reviewed the financial statements referred to above and, accordingly, do not express an opinion or any other form of assurance on them.

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

January 28, 20X6

[Signature of CPA]

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

[Name], President
[Company]
[Address]

We have compiled the accompanying balance sheet of [Company] as of [Date], 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 the [Name of Bank or Other Entity] information that is the representation of management. 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, we did become aware of a departure from the accounting standards prescribed by the [Name of Bank or Other Entity] that is described in the following paragraph.

The instructions that accompany the prescribed form require that [describe requirement]. Management has informed us that the company [describe deviation]. Management has not determined the effect of the departure on the accompanying financial statements.

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

January 28, 20X6

[Signature of CPA]

.09 Compilation Report—Personal Financial Statements; GAAP Basis

[Name]

[Address]

I (we) have compiled the accompanying statement of financial condition of James and Jane Person as of December 31, 20X5, and the related statement of changes in net worth for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the 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.

January 28, 20X6

[Signature of CPA]

.10 Compilation Report—Personal Financial Statements; GAAP Basis With GAAP Departure for Omission of Provision for Income Taxes

[Name]

[Address]

I (we) have compiled the accompanying statement of financial condition of James and Jane Person as of December 31, 20X5, 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. However, I (we) did become aware of a departure from generally accepted accounting principles that is described in the following paragraph.

As disclosed in Note X to the statement of financial condition, generally accepted accounting principles require that personal financial statements include a provision for estimated income taxes on the differences between the estimated current values of assets and estimated current amounts of liabilities and their tax bases. The accompanying statement of financial condition does not include such a provision and the effect of this departure from generally accepted accounting principles has not been determined.

January 28, 20X6

[Signature of CPA]

.11 Compilation Report—Personal Financial Statements; Tax Basis

[Name]

[Address]

I (we) have compiled the accompanying statement of assets, liabilities, and net worth—income tax basis of James and Jane Person as of December 31, 20X5, and the related statement of changes in net worth for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The financial statement(s) has (have) been prepared on the accounting basis used by the individuals 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 the individuals whose financial statements are presented. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X6

[Signature of CPA]

[The next page is 3001.]

AAM Section 3000

Engagement Planning and Administration

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

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

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

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

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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. The auditor should also be familiar with generally accepted auditing standards (GAAS), which are promulgated by the AICPA.

.03 Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* (AU section 411), as amended, 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 (AU section 411), as amended, also applies to compilation and review engagements.

.04 SAS No. 69 (AU section 411), as amended:

- a. Presents three separate but parallel hierarchies—one for state and local governments, another for nongovernmental entities, and another for federal governmental entities.
- b. Establishes a true GAAP hierarchy—each successive category in the hierarchy is a different level of authority.

.05 The table below in paragraph .06 summarizes the pronouncements that are included in each of the five categories of GAAP for nongovernmental entities, state and local governments, and federal governmental entities. This Manual does not take into account federal governmental entities.

.06 GAAP Hierarchy Summary*

Nongovernmental Entities	State and Local Governments	Federal Governmental Entities
	Established Accounting Principles	
.10a FASB Statements and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins	.12a GASB Statements and Interpretations, plus AICPA and FASB pronouncements if made applicable to state and local governments by a GASB Statement or Interpretation	.14a FASAB Statements and Interpretations plus AICPA and FASB pronouncements if made applicable to federal governmental entities by a FASAB 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	.14b FASAB Technical Bulletins and the following pronouncements if specifically made applicable to federal governmental entities by the AICPA and cleared by the FASAB: 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	.14c AICPA AcSEC Practice Bulletins if specifically made applicable to federal governmental entities and cleared by the FASAB and Technical Releases of the Accounting and Auditing Policy Committee of the FASAB
.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	.14d Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the federal government

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

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

Nongovernmental Entities	State and Local Governments	Federal Governmental Entities
Other Accounting Literature ^{††}		
<p>.11 Other accounting literature, including FASB Concepts Statements; AICPA Issues Papers; International Accounting Standards Committee Statements; GASB Statements, Interpretations, and Technical Bulletins; FASAB 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</p>	<p>.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; FASAB Statements, Interpretations, Technical Bulletins, and 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</p>	<p>.15 Other accounting literature, including FASAB Concepts Statements; pronouncements in categories (a) through (d) of the hierarchy in paragraph .10 when not specifically made applicable to federal governmental entities; FASB Concepts Statements; GASB Statements, Interpretations, Technical Bulletins, and Concepts Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; pronouncements of other professional associations or regulatory agencies; AICPA <i>Technical Practice Aids</i>; and accounting textbooks, handbooks, and articles</p>

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

Generally Accepted Auditing Standards

.07 An independent auditor plans, conducts and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. Auditing procedures differ from auditing standards. Auditing procedures are acts that the auditor performs during the course of an audit to comply with auditing standards.

.08 SAS, *Generally Accepted Auditing Standards* (AU section 150), provides a framework of GAAS.

.09 The general, field work, and reporting standards (the 10 standards) approved and adopted by the membership of the AICPA, as amended by the AICPA Auditing Standards Board (ASB), are as follows:

General Standards

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

Standards of Fieldwork

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. 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.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Informative disclosure in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

.10 Rule 202, *Compliance With Standards* (ET section 202.01) of the AICPA *Code of Professional Conduct*, requires an AICPA member who performs an audit (the auditor) to comply with standards promulgated by the ASB. The ASB develops and issues standards in the form of SASs through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs are codified within the framework of the 10 standards.

.11 The auditor should have sufficient knowledge of the SASs to identify those that are applicable to his audit. The nature of the 10 standards and the SASs requires the auditor to exercise professional judgment in applying them. Materiality and audit risk also underlie the application of the 10 standards and the SASs, particularly those related to field work and reporting. The auditor should be prepared to justify departures from the SASs.

.12 *Interpretive Publications* consist of auditing interpretations of the SASs, appendixes to the SASs,¹ auditing guidance included in AICPA Audit and Accounting Guides, and AICPA Auditing Statements of Position. Interpretive publications are not auditing standards. Interpretive publications are recommendations on the application of the SASs in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the ASB after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs.

.13 The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he complied with the SAS provisions addressed by such auditing guidance.

.14 *Other Auditing Publications* include:

- AICPA auditing publications not referred to above
- Auditing articles in the *Journal of Accountancy* and other professional journals
- Auditing articles in the *AICPA CPA Letter*
- Continuing professional education programs and other instructional materials, textbooks, guide books, audit programs and checklists; and other auditing publications from state CPA societies, other organizations and individuals.

Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the SASs.

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

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¹ Appendixes to the SASs referred to in paragraph 5 of SAS No. 95, *Generally Accepted Auditing Standards* (AU section 150.05), do not include previously issued appendixes to original pronouncements that when adopted modified other SASs.

AAM Section 3110

Assigning Personnel to the Engagement

General Comments

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

.02 Some procedures regarding assignment of personnel to the engagement are discussed in this section. The specific procedures adopted by a firm would not necessarily include all the procedures or be limited to those discussed. Overall firm requirements for assigning personnel to engagements are addressed in the *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* at AAM section 11,200. Sample quality control forms are available at AAM section 11,300, which are helpful in assigning personnel to engagements.

Engagement Planning Procedures

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

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

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

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

- a. Engagement size and complexity

- b. Personnel availability
- c. Special expertise
- d. Timing of the work to be performed
- e. Continuity and periodic rotation of personnel
- f. Opportunities for on-the-job training

.07 The knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the level of risk for the engagement (see AAM section 3140). Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement.

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

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

[The next page is 3161.]

AAM Section 3115

Independence

General Comments

.01 AICPA professional standards require independence, in accordance with Rule 101, *Independence* (ET section 101.01), of the AICPA *Code of Professional Conduct*, for all attest engagements.¹ Attest engagements are those in which your firm attests—or affirms—that a client’s financial or other information is reasonably stated. Examples of attest services are—

- Financial statement audits.
- Financial statement reviews.
- Other attest services as defined in the Statements on Standards for Attestation Engagements.

.02 Third parties—investors, creditors, and others—rely on your firm’s attestations about a client’s financial information when making various business decisions. Therefore, attest services have value for third parties only if an *independent firm* renders the services. Accordingly, AICPA professional standards require independence when your firm provides attest services; your firm may perform attest services for a client *only* when it is independent of that client. Independence is not required to perform the following services, if these are the *only* services your firm provides to a client:

1. Tax preparation and advice.
2. Consulting services (such as tax consulting or personal financial planning).

.03 One other service—a compilation of a client’s historical financial statements—does not require independence. If a nonindependent firm issues a compilation report, the report must state, “I am (we are) not independent with respect to XYZ Company.”² Therefore, if your firm provides attest services to a client, your firm—and partners and professional employees of your firm—must comply with Rule 101, *Independence* (ET section 101.01), of the AICPA *Code of Professional Conduct*. In addition to the AICPA independence rules you and others in your firm may need to comply with the independence rules of other organizations.

.04 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 and the regulations of other organizations, as applicable (for example, the Securities and Exchange Commission, and the Department of Labor). The interpretations and rulings under rule 101 (ET section 101.01) of the AICPA rules of conduct contain examples of instances wherein a firm’s independence will be considered to be impaired.

.05 Firms that are members of the SEC Practice Section of the AICPA Division for CPA Firms may have additional independence requirements. In addition, the SEC Practice Section sets forth minimum requirements for a firm’s independence quality control system.

.06 Other organizations that have established other independence requirements that may be applicable to you and your firm include:

¹ There are additional requirements for public companies and companies subject to other governmental oversight.

² Statements on Standards for Accounting and Review Services No. 1, *Compilation and Review of Financial Statements*, paragraph 19 (AR section 100.19).

- State boards of Accountancy
- State CPA Societies
- Federal and State Agencies

.07 Generally, the AICPA independence rules will apply to you in all situations involving an attest client. If an additional set of rules governing an engagement also applies, you should comply with the most restrictive rule or the most restrictive portions of each rule. See AAM section 3115.60 for an audit engagement checklist addressing compliance with AICPA independence rules.

Maintaining Your Independence

.08 Maintaining your independence is your responsibility, not your firm's. As part of its quality control system, the firm is required to address independence matters; however, ultimately it is up to you to follow firm policies and the independence rules. Many firms require you to certify your independence on a regular basis. The following are some suggestions that will help you to complete and sign that certification in good faith.

.09 *Gain an understanding of the independence rules and firm policies.* As a prerequisite to establishing and maintaining the independence of you and your firm, you must have a good, working understanding of the basic independence rules. At a minimum, you should be aware of the circumstances in which you and your immediate family meet the definition of a covered member and of the types of relationships you may have with the firm's clients that could impair independence. If you have any questions about independence matters, you should consult with someone in your firm who is knowledgeable about such matters, or you may seek the advice of the AICPA. If your firm performs audits and other attest services for SEC registrants, you should familiarize yourself with rules promulgated by the SEC and the Public Company Accounting Oversight Board (PCAOB), too.

Covered Member

.10 Know when you meet the definition of a covered member. Whenever you are a *covered member* with respect to a particular attest client, you become subject to the highest possible level of independence restrictions (for example, restrictions on financial and business interests, and your family's employment). You are a covered member with respect to a client if you are:

1. An individual on the attest engagement team;
2. An individual in a position to influence the attest engagement;
3. A partner or manager who provides more than ten hours of nonattest services to the attest client;
4. A partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement;
5. The firm, including the firm's employee benefit plans; or
6. An entity whose operating, financial, or accounting policies can be controlled (as defined by generally accepted accounting principles (GAAP) for consolidation purposes) by any of the individuals or entities described in (1) through (5) or by two or more such individuals or entities if they act together.

.11 However, there are two relationships that—due to their magnitude—impair independence even when you are *not* considered to be a covered member.

The following rules apply to all partners and professional employees of a firm:

- No partner or professional employee may be simultaneously employed by an attest client in any position or serve a client as a:
 - Director, officer (or any management capacity), or employee
 - Promoter, underwriter, or voting trustee
 - Trustee of any of the client's employee benefit plans
- No partner or professional employee may own greater than 5 percent of an attest client's outstanding equity securities (or other ownership interests).

Family Members

.12 The investments and employment of certain family members may impair your independence. Know which of your family members meet the definition of "immediate family" and which ones meet the definition of "close relative."

.13 If you are a covered member with respect to a client, members of your immediate family (your spouse—or equivalent—and your dependents) generally must follow the same rules as you. So, for example, your spouse's investments must be investments that you could own under the rules. This would be the case even if your spouse keeps the investments in his or her own name or with a different broker.

.14 There are two exceptions to this general rule.

1. Your immediate family member's employment with a client would not impair your firm's independence provided he or she is not in a "key position." A key position is one in which your family member
 - Has primary responsibility for significant accounting functions that support material components of the financial statements or the preparation of the financial statements;
 - Has primary responsibility for preparing the financial statements; or
 - Is able to influence the contents of the financial statements (for example, a chief executive officer, treasurer, or a member of the board of directors).
2. Immediate family members of *certain* covered members may have a financial interest in a client through an employee benefit plan (for example, retirement or savings account) provided the plan is offered equitably to all similar employees. The covered members whose families may have such interests are:
 - Partners and managers who provide only nonattest services to the client; and
 - Partners who are covered members *only* because they practice in the same office where the client's lead attest partner practices in connection with the engagement.

.15 Also note that immediate family of individuals on the attest engagement team *or* of those who can influence the attest engagement team may not apply this exception.

.16 Your immediate family is also prohibited from owning more than 5 percent of the client's outstanding equity securities.

.17 The close relatives of *certain* covered members will be subject to some employment and financial restrictions. These covered members are:

- Persons on the attest engagement team.
- Persons who can influence the attest engagement.

- Other partners in the office where the client's lead partner conducts the attest engagement.

.18 Close relatives are your:

- Nondependent children
- Siblings
- Parents

.19 So, as a covered member mentioned in Paragraph .17, your close relative's employment by a client would impair independence if your relative had a key position with the client.

.20 Rules pertaining to your close relatives' financial interests differ depending on whether you participate on the client's attest engagement as follows:

- If you participate on the client's attest engagement team, your independence would be considered to be impaired if you are aware that your close relative has a financial interest in the client that either:
 - Was material to your relative's net worth, **or**
 - Enables the relative to exercise significant influence over the client.
- If you are able to influence the client's attest engagement or are a partner in the office in which the lead attest engagement partner practices in connection with the engagement, your independence will be impaired if you are aware that your close relative has a financial interest in the client that:
 - Is material to your relative's net worth, **and**
 - Enables your relative to exercise significant influence over the client.

Financial Relationships

.21 There are various types of financial interests and some of those interests affect independence. Although your firm is also subject to the financial interest provisions of the independence rules (firms are included in the definition of *covered member*), here we focus on their application to individuals.

.22 As a covered member with respect to a particular client, you (and your spouse and dependents) may not have a:

- Direct financial interest in that client, regardless of how immaterial it would be to you.
- Material indirect financial interest in that client.

.23 In addition, if you commit to acquire a financial interest in a client with respect to which you are a covered member, your independence would be impaired.

.24 Examples of financial interests include shares of stock; mutual fund shares; partnership units; stock rights; options or warrants to acquire an interest in a client; or rights of participation, such as puts, calls, or straddles.

.25 Direct financial interests—as the name implies—are ownership interests held directly in a client (for example, you own shares of the client's stock). However, direct financial interests are also deemed to exist when you have a financial interest in a client through a:

- Retirement plan (for example, a 401(k) plan).
- Investment club.
- Blind trust.

.26 You also have a direct financial interest in a client when you have a financial interest in a client through a:

- Partnership if you are a general partner.
- Estate if you serve as an executor and meet certain other criteria.
- Trust if you serve as the trustee and meet certain other criteria.

.27 Indirect financial interests arise when you have a direct financial interest in one entity, Entity A, that itself has a direct financial interest in another entity, Entity B. In that situation, you would be considered to have an *indirect* financial interest in Entity B through your interest in Entity A. In this case, if Entity B is a client, you would be considered to have an investment in the client indirectly through your investment in the intermediate entity, Entity A. Examples of such intermediate entities are:

- Mutual funds (or similar entities).
- Partnerships when you are a limited partner.

Business Relationships

.28 As a partner or professional employee of your firm, independence would be considered to be impaired if you entered into certain business relationships with an attest client of the firm. Accordingly, you may not serve a client as a:

- Director, officer, employee, or act in any management capacity
- Promoter, underwriter, or voting trustee
- Stock transfer or escrow agent
- General counsel (or equivalent)
- Trustee for a client's pension or profit-sharing trust

.29 In essence, any time you are able to make management decisions on behalf of a client or exercise authority over a client's operations or business affairs, independence is considered impaired.

.30 Your independence is considered impaired even if you were a volunteer board member because you would be part of the client's governing body and therefore would be able to participate in the client's management decisions.

.31 There are two possible exceptions to this rule, as follows:

1. If you are an honorary director or trustee for a client that is a nonprofit charitable, civic, or religious organization, you may serve that client and not impair your firm's independence if:
 - Your position is purely honorary.
 - You do not vote or participate in managing the organization.
 - Your position is clearly identified as honorary in any internal or external correspondence.
2. In addition, you are also permitted to serve on a client's advisory board provided all the following criteria are met:
 - The advisory board's function is purely advisory.
 - The advisory board does not appear to make decisions for the client.
 - The advisory board and any decision-making boards are separate and distinct bodies.
 - Common membership between the advisory board and any decision-making groups is minimal.

Fee Issues

.32 Two types of fee arrangements, contingent fees and commissions, are prohibited when the arrangement involves an attest client, even though the fee is not related to an attest service.

.33 A contingent fee is an arrangement where (1) no fee is charged unless a specified result is attained or (2) the amount of the fee otherwise depends on the results of your firm's services. Some examples of contingent fees are:

- Your firm receives a "finder's fee" for helping a client locate a buyer for one of the client's assets.
- Your firm performs a consulting engagement to decrease a client's operating costs. The fee is based on a percentage of the cost reduction that the client achieves as a result of your service.

Exceptions are:

- Fees fixed by a court or other public authority.
- In tax matters, fees based on the results of judicial proceedings or the findings of governmental agencies.

.34 A commission is any compensation paid to you or your firm for (1) recommending or referring a third party's product or service to a client or (2) recommending or referring a client's product or service to a third party.

.35 For example, you or your firm:

- Refers a client to a financial planning firm that pays you a commission for the referral.
- Sells accounting software to a client and receives a percentage of the sales price (a commission) from a software company.
- Refers a nonclient to an insurance company client, which pays you a percentage of any premiums subsequently received (a commission) from the nonclient.

.36 The rule provides an exception for *referral fees* that are related to recommending or referring the services of a CPA. That is, you may (1) receive a fee for referring the services of a CPA to any person or entity or (2) if you are a CPA, pay a fee to obtain a client provided you disclose such receipt or payment to the client. Referral fees are not considered commissions under these specific circumstances.

.37 You and your firm may not have commission or contingent fee arrangements with a client when your firm also provides one of the following services to a client:

- An audit of financial statements.
- A review of financial statements.
- Compiled financial statements when a third party (for example, a bank or investor) will rely on the financial statements and the report does not disclose a lack of independence.
- An examination of prospective financial statements.

.38 You and your firm may have commission and contingent fee arrangements with persons associated with a client—such as officers, directors, and principal shareholders—or with a benefit plan that is sponsored by a client (that is, the plan itself is not a client).³ For example, you or your firm may receive a commission from an officer of a client without violating the AICPA rule. Even when permitted, the existence of a commission arrangement must be disclosed to the person (or entity) to whom the commission relates.

³ Also see AICPA Ethics Ruling No. 25 under section 391 of the *Code*, "Commission and Contingent Fee Arrangements With Nonattest Client" (ET section 391.049-.050).

Restricted Entities

.39 Be familiar with the firm's restricted entities. Restricted entities are those entities for whom the firm provides attest services. You should be aware of who these entities are. Many firms maintain a formal list or database of these clients. If yours is one of these firms, you should know how to access the list.

.40 Maintain the integrity of the restricted entity list. If you perform attest services, then you need to make sure that those clients are identified as restricted entities of the firm. Certain entities that are related to your clients (for example, subsidiaries) also will be considered restricted entities, even if they are not clients of the firm.

.41 Consult the restricted entities list regularly. Get into the habit of referring to the firm's restricted entity list whenever you are considering changes in circumstances that could affect your independence. For example, you should consult the restricted entity list prior to—

- Making an investment or acquiring a financial interest in an entity
- Entering into a business relationship
- Obtaining a loan
- Having an immediate family member change employers or assume new responsibilities at an existing job

Nonattest Services

.42 Be aware of the rules relating to the performance of nonattest services. If you provide nonattest services to restricted entities, you should be familiar with Ethics Interpretation No. 101-3 (ET section 101.05) regarding the performance of nonattest services. You should be aware of the services that are permitted and prohibited under the ruling, as well as your responsibilities for establishing an understanding of the engagement with your client and documenting various aspects of the engagement. If your clients are SEC registrants, you should be aware of the more restrictive SEC rules in this area. Certain other regulators (for example, the Government Accounting Office or GAO) may have more restrictive rules concerning nonattest services, which should be reviewed depending upon the circumstances of the engagement.

.43 The term, *nonattest services*, includes accounting and consulting services that are not part of an attest engagement.⁴ Nonattest services specifically addressed in the rules are:

- Bookkeeping services
- Payroll and other disbursement services
- Internal audit assistance
- Benefit plan administration
- Investment advisory or management services
- Corporate finance consulting or advisory
- Appraisal, valuation, or actuarial services
- Executive or employee search services
- Business risk consulting
- Information systems design, installation, or integration

⁴ Defined in the *Code of Professional Conduct*, an *attest engagement* is one that requires independence under AICPA *Professional Standards*, e.g., audits and reviews of financial statements or agreed-upon procedures performed under the attestation standards.

.44 Recently revised AICPA rules clarify the general requirements for performing nonattest services, adding a new pre-engagement documentation requirement. In addition, more restrictive rules will apply to certain services such as financial information system design and implementation and appraisal, valuation, and actuarial services. The new rules become effective on December 31, 2003, and incorporate a one-year transition period for services under contract as of that date provided the engagement is completed by December 31, 2004, and the member was in compliance with pre-existing independence requirements.

.45 One of the key principles underlying the AICPA rules on nonattest services is: You may not serve—or even appear to serve—as a member of a client’s management. For example, you may not:

- Make operational or financial decisions for the client.
- Perform management functions for the client.
- Report to the board of directors on behalf of management.

.46 In addition, the following are examples of the types of activities that impair independence:

- Authorizing or executing a transaction on behalf of a client
- Preparing the client’s source documents (for example, purchase orders)
- Having custody of a client’s assets

.47 Therefore, it is essential that your firm and the client have a clear understanding regarding your respective roles *before* performing nonattest services. The AICPA rules require you to document this understanding (e.g., in an engagement letter or internal memorandum). You are also required to document the services to be performed, objectives of the engagement and any applicable limitations, *and*, importantly, the client’s ability to effectively oversee your services.

.48 Another new addition to the AICPA rules is an explicit requirement that a member comply with more restrictive independence provisions, if applicable, of certain regulators such as state boards of accountancy, the SEC, and the GAO.

.49 *Report any apparent violations.* If you become aware of any apparent violations of the independence rules, you should report these immediately to the person in your firm responsible for independence matters.

.50 The procedures employed at the engagement level should be designed to ascertain whether the firm and its partners and employees have complied with all applicable independence rules. Overall firm requirements for independence are addressed in AICPA’s Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice*,^{*} paragraphs 7–10, as amended by SQCS No. 4, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice* (QC section 20.07–.10).

Independence Quality Controls

.51 The AICPA SQCSs include the following requirement.

Policies and procedures should be established to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances. (QC section 20.13)

^{*} SQCS No. 6, *Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm’s Accounting and Auditing Practice*, amends SQCS No. 2 (QC section 20), to clarify that deficiencies in individual audit, attest, review, and compilation engagements do not, in and of themselves, indicate that the firm’s system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards.

The professional standards do not describe how a firm should establish compliance with these requirements. However, in regards to independence matters, a CPA firm should consider the following.

.52 *Establish “plain English” independence policies and procedures.* Written policies and procedures are an important first step toward ensuring compliance with the independence rules. These policies should be written in a manner that is easy to read and understand.

.53 *Designate a partner-in-charge.* There are two reasons why a firm might wish to designate a partner-in-charge of independence matters. First, firm members who have questions about independence matters need to have someone to turn to for answers. It helps if they know there is one person in charge. Additionally, the independence rules are complicated and subject to change. A firm is more likely to have a good understanding of the independence rules when one person is specifically assigned the responsibility.

.54 *Communication and training.* The firm’s independence policies and procedures must be communicated throughout the firm. Periodic training on these matters will help ensure understanding and compliance.

.55 *Maintain a list of restricted entities.* Firm personnel must be independent with respect to the firm’s restricted entities. It is important for the firm to maintain a database or list of all clients (and certain related entities) for whom the firm performs services requiring independence. Policies and procedures should exist for keeping the list current.

.56 *Obtain written representations from firm personnel.* Many firms require their personnel to execute and return to the firm an independence representation in which the firm member affirms that he or she is independent with respect to the firm’s restricted entities. Typically, these representations are completed annually.

.57 *Resolution of apparent independence violations.* The firm should have procedures for resolving apparent independence violations that are reported by firm personnel.

Additional Guidance

.58 It is recommended that all procedures discussed in this section be documented in the auditor’s work papers.

.59 For additional guidance practitioners should refer to the AICPA *Plain English Guide to Independence*. The Guide discusses the independence rules of the principal standard-setting bodies in plain, straightforward English so you can understand and apply them with greater confidence and ease. The Guide will also help you identify issues that may require further investigation. The AICPA *Plain English Guide to Independence* summarizes the independence rules only; therefore, when assessing your independence, you should refer directly to the applicable independence standards, in addition to your firm’s policies on independence because they may include additional details or topics relevant to your situation. To obtain the Guide, visit the AICPA web site at www.aicpa.org and click on the Professional Ethics line presented in the left-hand column.

.60 Audit Engagement Checklist—Independence Compliance

(This Checklist is not intended to be all-inclusive of the kinds of relationships that may impair independence. Also, ET section references refer to AICPA Professional Standards, volume 2.)

Question	Answer and any Necessary Explanation
<p>1. Have covered members, including the firm (see ET section 92.06), had any of the following interests or relationships with the client during the period of the professional engagement?¹</p> <ul style="list-style-type: none"> • Financial interests (e.g., shares of stock; mutual fund shares; partnership units; stock rights; options or warrants to acquire an interest in a client; or rights of participation, such as puts, calls, or straddles) in the client, or leases, loans or other depository accounts with the client (see ET section 101.02, 101.07, 101.10, 101.13, 101.14,² and related ethics rulings in ET section 191) • Trustee or executor relationships when the trust or estate has a direct, or material indirect, financial interest in the client and the covered member had the authority to make investment decisions for the trust or estate or the interest meets other specified criteria (see ET section 101.02) • Joint, closely held investments with the client (see ET sections 92.15 and 101.02) • Immediate family (spouse, spousal equivalent, or dependent) with financial interests (including benefit plan holdings) in, or loans with, the client (see ET sections 92.11, 101.02, and 101.07) • Close relatives (sibling, nondependent child, or parent) with financial interests in the client (see ET sections 92.04 and 101.02) 	
<p>2. Have covered members, including the firm (see ET section 92.06), had any of the following interests or relationships with the client during the period of the professional engagement¹ or during the period covering the financial statements?</p> <ul style="list-style-type: none"> • Previous employment with the client and the covered member subsequently served on the client's attest engagement team or was in a position to influence the engagement, and the attest engagement covered the period when the individual was employed by the client (see ET sections 92.02, 92.12, and 101.02) • Previous service on the client's board of directors, or as a promoter, underwriter, voting trustee for the client, or as a trustee for the client's pension or profit-sharing trust and the covered member subsequently served on the client's attest engagement team or was in a position to influence the engagement, and the attest engagement covered the period when the individual was associated with the client (see ET sections 92.02, 92.12, and 101.02) • Immediate family members (spouse, spousal equivalent, or dependent) or close relatives (sibling, nondependent child, or parent) in key positions with the client (see ET sections 92.04, 92.11, 92.16, and 101.02) 	

Question	Answer and any Necessary Explanation
3. Have any partners or professional employees of the firm or the firm itself had any financial interests in the client exceeding 5 percent of the client's outstanding equity securities (or other ownership interests) during the period of the professional engagement ¹ (see ET section 101.02)?	
4. Have any partners or professional employees of the firm or the firm itself had any of the following interests or relationships with the client during the period of the professional engagement ² or during the period covering the financial statements? <ul style="list-style-type: none"> • Business relationships with the client, i.e., as an officer, director, employee, member of management, promoter, underwriter, voting trustee, trustee for client's pension or profit-sharing trust (see ET section 101.02 and related ethics rulings in ET section 191) • Cooperative arrangements with the client (see ET section 101.14) • Nonattest services engagements with the client (see ET section 101.05 and 101.15,³ and related ethics rulings in ET section 191) 	
5. Have any former partners or professional employees of the firm considered employment with the client while serving on the client's attest engagement team or while in a position to influence the attest engagement (see ET sections 92.02, 92.12, and 101.04)?	
6. Have any former partners or professional employees of the firm accepted key positions with the client (see ET sections 92.16 and 101.04)?	

The above checklist is not intended to be all-inclusive of the kinds of relationships that may impair independence.

¹ The period of the professional engagement begins when a member either signs an initial engagement letter or other agreement to perform attest services or begins to perform an attest engagement for a client, whichever is earlier. The period lasts for the entire duration of the professional relationship (which could cover many periods) and ends with the formal or informal notification, either by the member or the client, of the termination of the professional relationship or by issuance of a report, whichever is later. Accordingly, the period does not end with the issuance of a report and recommence with the beginning of the following year's attest engagement (ET section 92.24).

² ET section 101.16 relates to firms within an "alternative practice structure" only.

³ Effective December 31, 2003, Ethics Interpretation No. 101-13 guidance will be incorporated into Ethics Interpretation No. 101-3.

[The next page is 3181.]

AAM Section 3120

Knowledge of the Entity's Business

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

- a. Identifying areas that may need special consideration.
- b. Assessing conditions under which accounting data and corroborating evidential matter are produced, processed, reviewed, and accumulated within the operation.
- c. Evaluating the reasonableness of estimates, such as valuation of inventories, depreciation, allowances for doubtful accounts, and percentage-of-completion of long-term contracts.
- d. Evaluating the reasonableness of management representations.
- e. Making judgments about the appropriateness of the accounting principles applied and the adequacy of disclosures.¹
- f. Identifying information that should be considered in identifying risks of material misstatement due to fraud.

Engagement Planning Procedures

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

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

.04 The accountant should give thought to whether specialized skills are needed to consider the effect of computer processing on the audit, to understand the nature of controls or to design and perform audit procedures. If specialized skills are needed, the accountant should seek assistance from a professional who may be or may not be on the accountant's staff. If the use of such a professional is planned, the accountant should have sufficient computer-related knowledge to communicate the objectives of the other professional's work, to evaluate whether the specified procedures will meet the accountant's objectives, and to evaluate

¹ See SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, paragraphs 4 and 6 (AU section 411.04 and .06).

the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures. The accountant's responsibilities for using such a professional are equivalent to those for using assistants.²

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

- a. The extent to which computers and other information technology are used in every significant accounting application.
- b. Whether or not the application generates a financial statement line item or provides a basis for an accounting estimate.
- c. The significance of the financial statement line item(s) affected by the client's use of technology.
- d. The controls placed over the application or system.
- e. The effectiveness of the design and operation of those controls.³
- f. The complexity of the entity's information technology operations, including the use of an outside service center.⁴
- g. The organizational structure of the information technology activities.
- h. The availability of and access to evidence. Certain electronic evidence may exist at a certain point in time. However, such evidence may not be retrievable after a specified period of time if files are changed and if backup files do not exist.
- i. The use of computer-assisted audit techniques to increase the efficiency of performing audit procedures. Using computer-assisted audit techniques may also provide the accountant with an opportunity to apply certain procedures to an entire population of accounts or transactions. In addition, in some accounting systems, it may be difficult or impossible for the auditor to analyze certain data or test specific control procedures without computer assistance.

Practice Tip

The AICPA's Auditing Practice Release entitled, *Auditing With Computers*, provides practical and helpful guidance in using technology to your advantage during an audit. Call the AICPA at 1 (888) 777-7077 and ask for product number 021057.

² Since the use of a specialist who is effectively functioning as a member of the audit team is not covered by SAS No. 73, *Using the Work of a Specialist* (AU section 336), a computer audit specialist requires the same supervision and review as any assistant.

³ Paragraph 14 of SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to Statement on Auditing Standards No. 31, Evidential Matter* (AU section 326.14), states that 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. In such circumstances, the auditor should perform tests of controls to gather evidential matter to use in assessing control risk, or consider the effect on his report. Paragraph 4 of 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*, and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AU section 319.04), states that when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form, the auditor's ability to obtain the desired assurance only from substantive tests would significantly diminish.

⁴ See SAS No. 70, *Service Organizations*, as amended by SAS No. 88, *Service Organizations and Reporting on Consistency* (AU section 324), and the related AICPA Audit Guide, *Service Organizations. Applying SAS No. 70* (product number 012772), for guidance concerning the use of a service center for computer processing of significant accounting applications.

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

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

[The next page is 3201.]

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

AAM Section 3125

Consideration of Internal Control

Introduction

.01 Internal control is broadly defined as a process designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations. Internal control is 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 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*, and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (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 perform procedures to understand the design of controls (whether manual or automated) and determine 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" at a point in time is different from its "operating effectiveness" over a period of time. In obtaining knowledge about whether controls have been placed in operation, the auditor determines that the entity is using them. Operating effectiveness, on the other hand, is concerned with how the control (whether manual or automated) was applied, the consistency with which it was applied, and by whom it was applied. The auditor determines whether controls have been placed in operation as part of the understanding of internal control necessary to plan the audit. The auditor evaluates the operating effectiveness of controls as part of assessing control risk. Understanding internal control and assessing control risk may be performed concurrently in an audit, and some procedures performed to obtain the understanding may provide evidential matter about the operating effectiveness of controls relevant to certain assertions.

.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 effective 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 access controls, such as passwords that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, controls to prevent the excess use of materials in production generally are not relevant to a financial statement audit. An auditor's responsibility to understand internal control is generally limited to those controls relevant to the reliability of financial reporting.

.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 support the ability of the entity's people to identify, 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. Controls relevant to the audit are those that individually or in combination with others are likely to prevent or detect material misstatements in financial statement assertions. Such controls may exist in any of the five components.

.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, whether individually or in combination with other controls, affect financial statement assertions relating to cash.*

How an Auditor Obtains an Understanding of Internal Control

.25 An auditor often obtains a sufficient 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 20X1, Jones installed the general ledger system and the cash receipts/disbursements and accounts payable modules. As part of performing her 20X1 audit, Andrea Auditor obtained an understanding of the software package and the modules that were installed. For her 20X2 audit, Andrea should focus on changes made to the system since 20X1. For example, she might inquire about the installation of other modules (such as inventory) or updated versions of the software package.*

.29 Some controls are documented in policy and procedure manuals, flowcharts, source documents, journals, and ledgers. In these cases, inspection of the documentation and inquiries of entity personnel may provide a sufficient understanding to 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 making a judgment about the understanding of internal control necessary to plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatement that could occur, the risk that such misstatements may occur, and the factors that influence the design of tests of controls, when applicable, and substantive tests. Other sources of such knowledge include information from previous audits and the auditor's understanding of the industry and market in which the entity operates. The auditor also considers his or her assessment of inherent risk, judgments about materiality, and the complexity and sophistication of the entity's operations and systems, including the extent to which the entity relies on manual controls or on automated controls.

.33 In making a judgment about the understanding of internal control necessary to plan the audit, the auditor also considers IT risks that could result in misstatements. For example, if an entity uses IT to perform complex calculations, the entity receives the benefit of having the calculations consistently performed. However, the use of IT also presents risks, such as the risk that improperly authorized, incorrectly defined, or improperly implemented changes to the system or programs performing the calculations, or to related program tables or master files, could result in consistently performing those calculations inaccurately. As an entity's operations and systems become more complex and sophisticated, it becomes more likely that the auditor would need to increase his or her understanding of the internal control components to obtain the understanding necessary to design tests of controls, when applicable, and substantive tests.

.34 The auditor should consider whether specialized skills are needed for the auditor to determine the effect of IT on the audit, to understand the IT controls, or to design and perform tests of IT controls or substantive tests. A professional possessing IT skills may be either on the auditor's staff or an outside professional. In determining whether such a professional is needed on the audit team, the auditor considers factors such as the following:

- The complexity of the entity's systems and IT controls and the manner in which they are used in conducting the entity's business
- The significance of changes made to existing systems, or the implementation of new systems
- The extent to which data is shared among systems
- The extent of the entity's participation in electronic commerce
- The entity's use of emerging technologies
- The significance of audit evidence that is available only in electronic form

.35 Procedures that the auditor may assign to a professional possessing IT skills include inquiring of an entity's IT personnel how data and transactions are initiated, recorded, processed, and reported and how IT controls are designed; inspecting systems documentation; observing the operation of IT controls; and

planning and performing tests of IT controls. If the use of a professional possessing IT skills is planned, the auditor should have sufficient IT-related knowledge to communicate the audit objectives to the professional, to evaluate whether the specified procedures will meet the auditor's objectives, and to evaluate the results of the procedures as they relate to the nature, timing, and extent of other planned audit procedures.

.36 The auditor's assessment of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature, timing, 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.

.37 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.

Documenting the Understanding

.38 The auditor should document the understanding of the entity's internal control components obtained to plan the audit. The form and extent of this documentation is influenced by the nature and complexity of the entity's controls. For example, documentation of the understanding of internal control of a complex information system in which a large volume of transactions are electronically initiated, recorded, processed, or reported may include flowcharts, questionnaires, or decision tables. For an information system making limited or no use of IT or for which few transactions are processed (for example, long-term debt), documentation in the form of a memorandum may be sufficient. Generally, the more complex the entity's internal control and the more extensive the procedures performed by the auditor, the more extensive the auditor's documentation should be.

Using Internal Control Information to Plan the Audit

.39 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 determining 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.

.40 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.

.41 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.

.42 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.

.43 The auditor uses the understanding of internal control to plan an audit strategy for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. There are generally two types of audit strategies:

- A substantive approach (however, see paragraph .44 below), where control risk is assessed at or slightly below the maximum level¹, or
- An approach where control risk is assessed below the maximum level.

.44 To use a substantive approach, the auditor needs to be satisfied that performing only substantive tests would be effective in restricting detection risk to an acceptable level. **When a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, or reported, the auditor may determine that it is not possible to assess control risk at the maximum and design effective substantive tests that by themselves would provide sufficient evidence that the assertions are not materially misstated.** For such assertions, significant audit evidence may be available only in electronic form and its competence and sufficiency as evidential matter usually depend on the effectiveness of controls over its accuracy and completeness. Also, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively. For example, a purchase order transmitted electronically from a customer derives its credibility primarily from the controls within the electronic environment. A fraudulent or altered electronic purchase order exhibits no apparent difference, compared to a valid purchase order, when extracted from the electronic environment of the entity. Without testing the internal control surrounding the electronic evidence, a lack of credibility may not be recognized by the auditor. In such circumstances, the auditor should perform tests of controls surrounding the electronic environment to gather evidential matter to use in assessing control risk, or consider the effect on the auditor's report.

Practice Tip

The AICPA has published a practice aid entitled, *The Information Technology Age: Evidential Matter in the Electronic Environment* (product number 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 (888) 777-7077 for more information.

.45 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.

.46 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.

.47 *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.*

.48 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.

¹ The term *maximum level* means the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control.

Choosing an Audit Strategy

.49 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 .44 above.

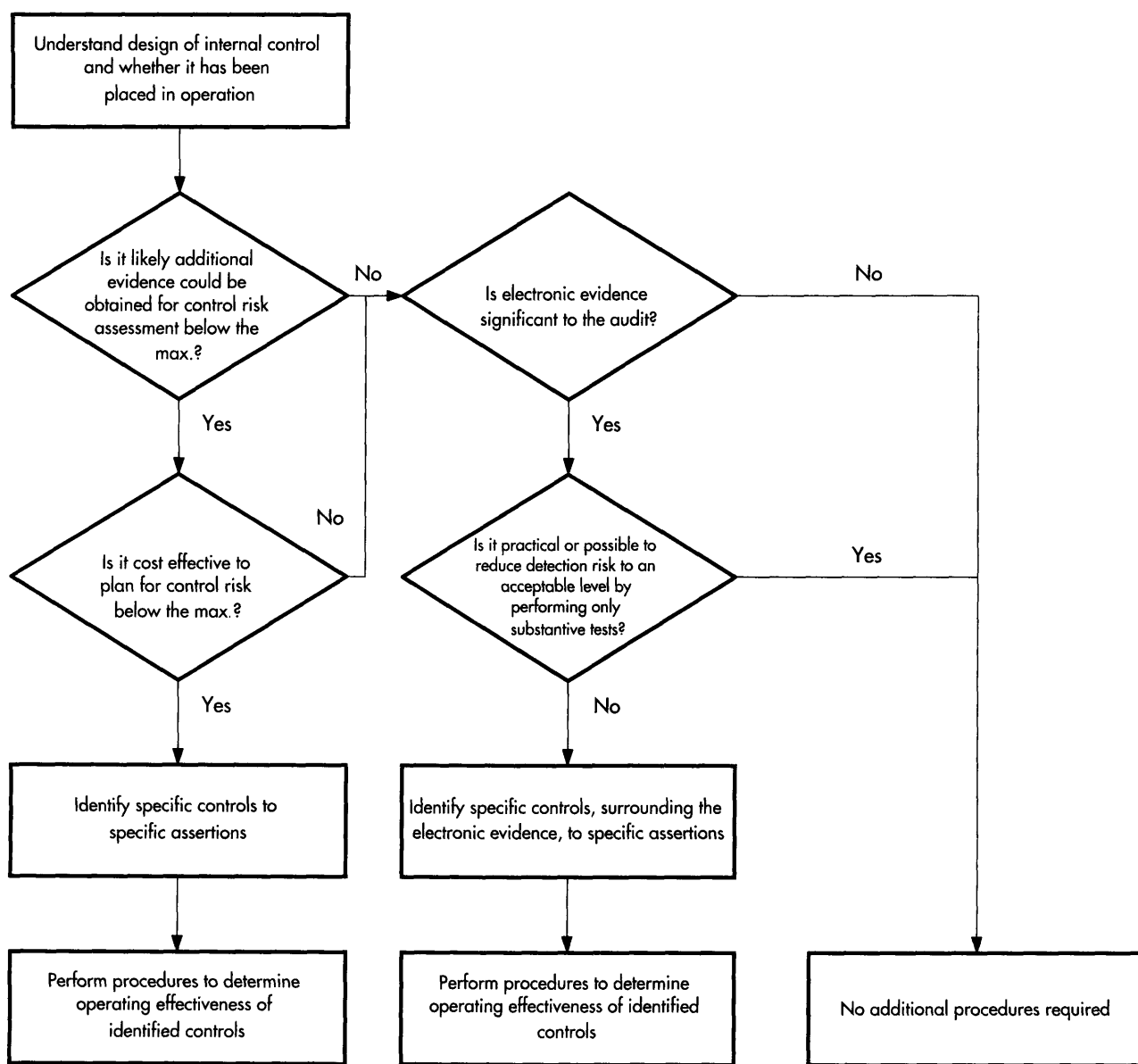
.50 In order to assess control risk below the maximum, the auditor must also:

- 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.

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

.52 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, substantive tests alone may not provide sufficient evidence in environments where electronic evidence is significant, especially when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form.

.53 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*, as amended by SAS No. 89, *Audit Adjustments* (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.

Practice Tip

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

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

Special Considerations

.07 The following matters should be considered while 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.
- Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

.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 documentation. 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 documentation 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.

[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. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. In other words, audit risk is the risk that the auditor will issue an unqualified opinion on financial statements that are materially incorrect.

.02 Financial statements are **materially** misstated when they contain misstatements whose effect, individually or in the aggregate, are important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles. 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 omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."

Material Misstatements

.03 Misstatements can result from errors or fraud.¹

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.

.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.

¹ 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.

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		
<p>.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.</p> <p>.21 A sample checklist documenting procedures listed in this section is located in AAM section 3165.</p>		

SEC Staff Bulletin on Materiality for SEC Registrants

.22 The SEC staff has released SAB No. 99, *Materiality*. This SAB addresses the application of materiality thresholds to the preparation and audit of financial statements filed with the SEC. The SAB does not create new standards or definitions for materiality, but reaffirms the concepts of materiality as expressed in the accounting and auditing literature as well as in long-standing case law.

.23 The SAB states that registrants and the auditors of their financial statements should not rely exclusively on quantitative benchmarks to determine whether an item is material to the financial statements. Equally important is a consideration of whether, in light of the surrounding circumstances, a reasonable investor would consider the item to be important. The SAB also states that management should not make intentional immaterial errors in a registrant's financial statements to "manage" earnings. It further reminds registrants of their legal responsibility to make and keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect transactions and the disposition of assets. The SAB reminds auditors of their obligations to inform management and, in some cases, audit committees of illegal acts that come to the auditor's attention. The full text of the SAB can be viewed at the SEC Web site at: www.sec.gov/rules/acctreps/sab99.htm.

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

.24 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.

.25 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

.26 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.

.27 **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.

.28 **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.

.29 **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.

.30 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

.31 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.

.32 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.

.33 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

.34 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.

.35 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

.36 In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, the auditor should consider the effects, both individually and in the aggregate, of misstatements that are not corrected by the entity. In evaluating the effects of misstatements, the auditor should include both qualitative and quantitative considerations (see SAS No. 47 [AU section 312.08–.11]). The consideration and aggregation of misstatements should include the auditor's best estimate of the total misstatements in the account balances or classes of transactions that he or she has examined (hereafter referred to as likely misstatements,² see AAM section 3140.37–.40, below), not just the amount of misstatements specifically identified, (hereafter referred to as known misstatements, see AAM section 3140.41, below). Likely misstatements should be aggregated in a way that enables the auditor to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole. Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material.

Likely Misstatements

.37 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."

.38 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.

.39 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.

.40 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

.41 "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.

² The term *likely misstatements* includes any known misstatements.

Misstatements From the Prior Year

.42 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

.43 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.

.44 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.

.45 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.

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

Audit Documentation

.47 SAS No. 96, *Audit Documentation* (AU section 339), amends SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312.40). This amendment adds a requirement to SAS No. 47 (AU section 312) to document the nature and effect of misstatements that the auditor aggregates as well as the auditor's conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated.

[The next page is 3291.]

AAM Section 3145

Fraud

General

In October 2002, the Auditing Standards Board issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU section 316), which supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AU section 316A), and amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AU section 230). SAS No. 99 establishes standards and provides guidance to auditors in fulfilling their responsibility as it relates to fraud in an audit of financial statements conducted in accordance with generally accepted auditing standards. It does not change the auditor's 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. However, the statement does establish standards and provide guidance to auditors fulfilling that responsibility, as it relates to fraud. Practitioners should also be aware that the AICPA has published a Practice Aid, *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*, to assist auditors in applying the new SAS.

.01 SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor*, as amended by SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (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 design and implementation of programs and controls to prevent, deter, and detect 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 assurances that material misstatements due to fraud are detected. An auditor is not responsible for detecting immaterial misstatements caused by fraud. SAS No. 99 (AU section 316.03), describes the auditor's consideration of fraud as something that should be integrated into the overall audit process. SAS No. 99 (AU section 316) describes a process in which the auditor:

- Exercises professional skepticism
- Discusses the risks of material misstatements due to fraud with engagement personnel
- Gathers information needed to identify risks of material misstatement due to fraud
- Identifies risks that may result in a material misstatement due to fraud
- Assesses the identified risks after taking into account an evaluation of the entity's programs and controls that address the risks
- Responds to the results of the assessment
- Evaluates audit evidence
- Communicates about fraud to management, the audit committee, and others
- Documents the auditor's consideration of fraud

.03 Even though some requirements and guidance set forth in SAS No. 99 are presented in a manner that suggests a sequential audit process, auditing in fact involves a continuous process of gathering, updating, and

analyzing information throughout the audit. Accordingly, the sequence of the requirements and guidance in SAS No. 99 may be implemented differently among audit engagements.

Description and Characteristics of Fraud

.04 The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement in financial statements is intentional or unintentional. SAS No. 99 defines fraud as an intentional act that results in a material misstatement in financial statements that are the subject of an audit.

.05 Three conditions generally are present when fraud occurs. First, management or other employees have an incentive or are under pressure, which provides a reason to commit fraud. Second, circumstances exist that provide an opportunity for a fraud to be perpetrated. Third, those involved are able to rationalize committing a fraudulent act.

Misstatements Arising From Fraudulent Financial Reporting

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

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

Misstatements Arising From Misappropriation of Assets

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

The Importance of Exercising Professional Skepticism

.08 Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence, and requires an ongoing assessment of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

.09 SAS No. 99 requires that members of the audit team discuss the potential for material misstatement due to fraud prior to or in conjunction with his or her information-gathering procedures. The discussion should include:

- An exchange of ideas or “brainstorming” among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity’s financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.
- An emphasis on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud.

.10 Communication among the audit team members about the risks of material misstatement due to fraud should continue throughout the audit. See paragraphs 14 through 18 of SAS No. 99 (AU section 316.14–.18), for further guidance.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

.11 In obtaining knowledge about the entity’s business and the industry in which it operates, information may come to the auditor’s attention that should be considered in identifying risks of material misstatements due to fraud. The auditor should perform procedures to obtain information that is used to identify the risks of material misstatement due to fraud, including:

- Making inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed.
- Considering any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit.
- Considering whether one or more fraud risk factors exist.
- Considering other information that may be helpful in identifying risks of material misstatement due to fraud.

See paragraphs 19 through 34 of SAS No. 99 (AU section 316.19–.34) for further guidance.

.12 Although fraud usually is concealed and management’s intent is difficult to determine, the presence of certain risk factors or other conditions may suggest to the possibility that fraud may exist. However, these conditions may be the result of circumstances other than fraud.

.13 The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error. Because fraud is usually concealed, material misstatements due to fraud are difficult to detect. Nevertheless, the auditor may identify “fraud risk factors” that do not necessarily indicate the existence of fraud, but often are present in circumstances where fraud exists. A fraud risk factor is an event or condition that indicates:

- An incentive or pressure to perpetrate fraud
- Opportunities to carry out the fraud
- Attitudes or rationalizations to justify a fraudulent action

Identifying Risks That May Result in a Material Misstatement Due to Fraud

.14 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in the context of the three conditions present when a material misstatement

due to fraud occurs—that is, incentives/pressures, opportunities, and attitudes/rationalizations. However, the auditor should not assume that all three conditions must be observed or evident before concluding that there are identified risks.

.15 The identification of a risk of material misstatement due to fraud involves the application of professional judgment and includes the consideration of the attributes of the risk, including:

- The type of risk that may exist, that is, whether it involves fraudulent financial reporting or misappropriation of assets.
- The significance of the risk, that is, whether it is of a magnitude that could lead to result in a possible material misstatement of the financial statements.
- The likelihood of the risk, that is, the likelihood that it will result in a material misstatement in the financial statements.
- The pervasiveness of the risk, that is, whether the potential risk is pervasive to the financial statements as a whole or specifically related to a particular assertion, account, or class of transactions.

.16 SAS No. 99 identifies two new requirements for identifying risks that may result in a material misstatement due to fraud. The auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. In addition, the risk of management override of controls should be considered a fraud risk on every audit.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

.17 As part of the understanding of internal control sufficient to plan the audit required by SAS No. 55 (AU section 319), the auditor should evaluate whether entity programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation, and assess those risks taking into account that evaluation.

Responding to the Results of the Assessments

.18 The auditor's response to the assessment of the risks of material misstatement due to fraud involves the application of professional skepticism in gathering and evaluating audit evidence and is influenced by the nature and significance of the risks identified as being present and the entity's programs and controls that address these identified risks. The auditor's response can be (1) an overall response on how the audit is conducted, (2) a response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed, or (3) a response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur.

.19 The auditor may conclude that it would not be practicable to design auditing procedures that sufficiently address the risks of material misstatement due to fraud. In that case, withdrawal from the engagement with communication to the appropriate parties may be an appropriate course of action.

Overall Responses to the Risk of Material Misstatement

.20 Judgements about the risk of material misstatement due to fraud have an overall effect on how the audit is conducted in the following ways:

- *Assignment of personnel and supervision.* The knowledge, skill, and ability of personnel assigned significant engagement responsibility should be commensurate with the auditor's assessment of the risks of material misstatement due to fraud for the engagement. In addition, the extent of supervision should reflect the risks of material misstatement due to fraud.
- *Accounting principles.* The auditor should consider management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions.
- *Predictability of auditing procedures.* The auditor should incorporate an element of unpredictability in the selection from year to year of auditing procedures to be performed.

Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed to Address the Identified Risks

.21 The auditing procedures performed in response to identified risks of material misstatement due to fraud will vary depending on upon the types of risks identified and the account balances, classes of transactions, and related assertions that may be affected. These procedures may involve both substantive tests and tests of the operating effectiveness of the entity's programs and controls. The auditor's responses to address specifically identified risks of material misstatement due to fraud may include changing the nature, timing, and extent of auditing procedures. See paragraphs 52 through 56 of SAS No. 99 (AU section 316.52–.56) for more guidance.

Responses to Further Address the Risk of Management Override of Controls

.22 Management is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively. Accordingly, in addition to overall responses and responses that address specifically identified risks of material misstatement due to fraud, certain procedures should be performed to further address the risk of management override of controls, as discussed in paragraphs 58 through 67 of SAS No. 99 (AU section 316.58–.67).

Evaluating Audit Evidence

.23 The auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit. The auditor should consider whether analytical procedures performed in planning the audit result in identifying any unusual or unexpected relationships that should be considered in assessing the risks of material misstatements due to fraud. The auditor also should evaluate whether analytical procedure that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud.

.24 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of audit procedures and other observations affect the assessment of the risk of material misstatement due to fraud made earlier in the audit. Such an evaluation may provide further insight into the risk of material misstatement due to fraud and whether there is a need for additional or different audit procedures to be performed.

.25 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, especially those dealing with the organizational position of the person(s)

involved. If the matter involves higher-level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem, for example, implications about the integrity of management. In such circumstances, the auditor should reevaluate the assessment of the risk of material misstatement due to fraud and its resulting impact on (a) the nature, timing, and extent of the tests of balances or transactions and (b) the assessment of the effectiveness of controls if control risk was assessed below the maximum.

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

- Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.
- Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee.
- Consider the implications for other aspects of the audit.
- If appropriate, suggest that the client consult with legal counsel.

.27 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. Whether the auditor concludes that withdrawal from the engagement is appropriate may depend on (a) the implications about the integrity of management and (b) the diligence and cooperation of management or the board of directors in investigating the circumstances and taking appropriate action. Because of the variety of circumstances that may arise, it is not always possible to definitely describe when withdrawal is appropriate. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Communicating About Possible Fraud to Management, the Audit Committee, and Others

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.

.28 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. In addition, the auditor should reach an understanding with the audit committee regarding the nature and extent of communications with the committee about misappropriations perpetrated by lower-level employees.

.29 If the auditor, as a result of the assessment of the risks of material misstatement, has identified risks of material misstatement due to fraud that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected) the auditor should consider whether these risks represent reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit committee. Also the auditor should consider whether the absence

of or deficiencies in programs and controls to mitigate specific risks of fraud or to otherwise help prevent, deter, and detect fraud represent reportable conditions that should be communicated to senior management and the audit committee.

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

- To comply with certain legal and regulatory requirements.
- To a successor auditor when the successor makes inquiries in accordance with 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 of client matters may be complex, the auditor may wish to consult with legal counsel before discussing matters of fraud or possible fraud with parties outside the client.

Documenting the Auditor's Consideration of Fraud

.31 The auditor should document the following:

- The discussion among engagement personnel in planning the audit regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, including how and when the discussion occurred, the audit team members who participated, and the subject matter discussed
- The procedures performed to obtain information necessary to identify and assess the risks of material misstatement due to fraud
- Specific risks of material misstatement due to fraud that were identified, and a description of the auditor's response to those risks
- If the auditor has not identified in a particular circumstance, improper revenue recognition as a risk of material misstatement due to fraud, the reasons supporting the auditor's conclusion
- The results of the procedures performed to further address the risk of management override of controls
- Other conditions and analytical relationships that caused the auditor to believe that additional auditing procedures or other responses were required and any further responses the auditor concluded were appropriate, to address such risks or other conditions
- The nature of the communications about fraud made to management, the audit committee, and others

Using the AICPA Audit and Accounting Manual in Considering Fraud

.32 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. 99 (AU section 316).

.33 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.

.34 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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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 (AU section 312).) 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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AAM Section 3155

Analytical Procedures

General Comments

.01 Analytical procedures are a natural extension of the auditor's understanding of the client's business, and add to his or her understanding because the key factors that influence the client's business may be expected to affect the client's financial information. Analytical procedures are used in all three stages of the audit. In the planning stage, the purpose of analytical procedures is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain evidential matter for specific account balances or classes of transactions.¹ In the substantive testing stage of the audit, the purpose of analytical procedures is to obtain evidence, sometimes in combination with other substantive procedures, to identify misstatements in account balances and thus to reduce the risk that misstatements will remain undetected.² In the overall review stage, the objective of analytical procedures is to assist the auditor in assessing the conclusions reached and in evaluating the overall financial statement presentation. In all cases, the effectiveness of analytical procedures lies in developing expectations that can reasonably be expected to identify unexpected relationships.

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

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

Analytical Procedures

.03 Analytical procedures are defined by SAS No. 56 (AU section 329.02), as amended, as "evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. . . . A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of conditions to the contrary." The definition implies several key concepts.

- The "evaluations of financial information" suggests that analytical procedures will be used to understand or test financial statement relationships or balances.
- The "study of plausible relationships" implies an understanding of what can reasonably be expected and involves a comparison of the recorded book values with an auditor's expectations.

¹ Analytical procedures in the planning stage of the audit may also be useful in understanding the client's business. In understanding the business, auditors can use the results from analytical procedures to assess auditors' business risk (refer to SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312)).

² The auditors' use of substantive tests to achieve an audit objective related to a particular assertion may be supported by test of details, analytical procedures, or a combination. The decision about which tests to use to reduce the risk that a material misstatement will not be detected is based on the auditor's judgment about the expected effectiveness and efficiency of the available procedures (cost/benefit).

- “Relationships among both financial and nonfinancial data” suggests that both types of data can be useful in understanding the relationships of the financial information and, therefore, in forming an expectation.

.04 Analytical procedures performed in the planning stage are used to identify unusual changes in the financial statements, or the absence of expected changes, and specific risks. During the planning stage, analytical procedures are usually focused on account balances aggregated at the financial statement level and relationships between account balances.

.05 Analytical procedures performed during the overall review stage are designed to assist the auditor in assessing that (a) all significant fluctuations and other unusual items have been adequately explained and (b) the overall financial statement presentation makes sense based on the audit results and the auditor’s knowledge of the business.

.06 During the substantive testing stage, analytical procedures are performed to obtain assurance that material misstatements are not likely to exist in financial statement account balances. To do this, the auditor focuses his or her analytical procedures on particular assertions about account balances and gives detailed attention to the underlying factors that affect those account balances through the development of an expectation independent of the recorded balance. Therefore, substantive analytical procedures generally are performed with more rigor and precision than those used for planning or overall review.

Analytical Procedure Process: Four Phases

.07 The use of analytical procedures can be considered a process that consists of four phases. The first phase is the expectation-formation process. In this phase, the auditor forms an expectation of an account balance or financial relationship. In doing so, the auditor determines the precision of the expectation and thus, in part, the effectiveness of the analytical procedure.

.08 The remaining three phases consist of the identification, investigation, and evaluation of the difference between the auditor’s expected value and the recorded book value in light of the auditor’s materiality assessment. In the second phase, identification, the auditor identifies whether an unusual fluctuation exists between the expected and recorded amounts. In the third, investigation, the auditor investigates the cause of unexpected differences by considering possible causes and searching for information to identify the most probable causes. Finally, in the evaluation phase, the auditor evaluates the likelihood of material misstatement and determines the nature and extent of any additional auditing procedures that may be required.

Expectation Formation (Phase I)

.09 Forming an expectation is the most important phase of the analytical procedure process. The more precise the expectation (that is, the closer the auditor’s expectation is to the correct balance or relationship), the more effective the procedure will be at identifying potential misstatements. Also, SAS No. 56 (AU section 329) requires the auditor to form an expectation whenever he or she applies analytical procedures.

.10 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.

.11 The effectiveness of an analytical procedure is a function of three factors related to the precision with which the expectation is developed: (a) the nature of the account or assertion, (b) the reliability and other characteristics of the data, and (c) the inherent precision of the expectation method used.

Identification and Investigation (Phases II and III)

.12 The next two phases of the analytical procedure process consist of identification and investigation. Identification begins by comparing the auditor's expected value with the recorded amount. Given that the auditor developed an expectation with a particular materiality threshold in mind, he or she then compares the unexpected differences with the threshold. In substantive testing, an auditor testing for the possible misstatement of the book value of an account determines whether the audit difference was less than the auditor's materiality threshold. If the difference is less than the acceptable threshold, taking into consideration the desired level of assurance from the procedure, the auditor accepts the book value without further investigation. If the difference is greater, the next step is to investigate the difference.

.13 In investigation, the auditor considers possible explanations for the difference. The greater the precision of the expectation (that is, the closer the expectation is to the correct amount) the greater the likelihood that the difference between the expected and recorded amounts is due to misstatement rather than nonmisstatement causes. The difference between an auditor's expectation and the recorded book value of an account (value of an account not subject to auditing procedures) can be due to any or all of the following three causes: (a) the difference is due to misstatements, (b) the difference is due to inherent factors that affect the account being audited (for example, the predictability of the account or account subjectivity), and (c) the difference is due to factors related to the reliability of data used to develop the expectation (for example, data that have been subject to auditing procedures versus data that have not been subject to auditing procedures). The greater the precision of the expectation, the more likely the difference between the auditor's expectation and the recorded value will be due to misstatements (cause a). Conversely, the less precise the expectation, the more likely the difference is due to factors related to the precision of the expectation (causes b and c).

Evaluation (Phase IV)

.14 The final phase of the analytical procedure process consists of evaluating the difference between the auditor's expected value and the recorded amount. It is usually not practicable to identify factors that explain the exact amount of a difference identified for investigation. However, the auditor should attempt to quantify that portion of the difference for which plausible explanations can be obtained and, where appropriate, corroborated and determine that the amount that cannot be explained is sufficiently small to enable him or her to conclude on the absence of material misstatement.

.15 If a reasonable explanation can not be obtained, SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312.34), as amended, requires the auditor to "consider the effects, both individually and in the aggregate, of misstatements that are not corrected by the entity." The auditor should include both qualitative and quantitative considerations in evaluating the effects of misstatements. The consideration and aggregation of misstatements should include the auditor's best estimate of the total misstatements in the account balances or classes of transactions that he or she has examined (likely misstatements), not just the amount of misstatements specifically identified (known misstatements). Likely misstatements should be aggregated in a way that enables the auditor to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole.

Engagement Planning Procedures

.16 As stated above, 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.

.17 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.

.18 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.

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

Audit Documentation Requirements

.20 SAS No. 96, *Audit Documentation* (AU section 339), amends SAS No. 56, *Analytical Procedures* (AU section 329), by adding an audit documentation requirement with respect to substantive analytical procedures. When an analytical procedure is used as the principal substantive test of a significant financial statement assertion the auditor should document all of the following:

- The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.
- Results of the comparison of the expectation to the recorded amounts or ratios developed from the recorded amounts.
- Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.

Analytical Procedures Audit Guide

.21 For additional guidance practitioners should refer to the AICPA Audit Guide *Analytical Procedures*. The Guide provides practical guidance for auditors on the effective use of analytical procedures. Specifically, the Audit Guide includes a discussion of SAS No. 56 (AU section 329); concepts and definitions; a series of questions and answers, grouped in the following five categories: precision of the expectation, relationship of analytical procedures to the audit risk model, evaluation and investigation, purpose of analytical procedures, and fraud; and a case study illustrating the four types of expectation methods discussed in chapter 1 of the Guide: trend analysis, ratio analysis, reasonableness testing, and regression analysis.

.22 The Audit Guide also includes illustrations that demonstrate the importance of forming expectations and considering the precision of the expectation, two of the most misunderstood concepts from SAS No. 56 (AU section 329). The concepts discussed are applicable for all three stages of the audit (planning, substantive testing, and review). However, the Audit Guide focuses principally on how the concepts are applied to substantive testing because in designing substantive procedures, auditors ordinarily desire a specified level of audit assurance. To obtain the Audit Guide, call the AICPA order department at 888-777-7077.

[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>
.01 A. Understanding the Assignment			
1. Consider the following matters in planning the engagement:			
a. The entity's accounting policies and procedures.	_____	_____	_____
b. Financial statement items likely to require adjustment.	_____	_____	_____
c. The nature of reports expected to be rendered (for example, a report on consolidated or consolidating financial statements, reports on financial statements filed with the SEC, or special reports such as those on compliance with contractual provisions).	_____	_____	_____
2. In planning the audit:			
a. Discuss the type, scope, and timing of the audit with the entity's management, board of directors, or audit committee.	_____	_____	_____
b. Consider the effects of applicable accounting and auditing pronouncements, particularly new ones.	_____	_____	_____
c. Coordinate the assistance of entity personnel in information preparation.	_____	_____	_____
d. Determine the extent of involvement, if any, of consultants, other independent auditors, specialists, and internal auditors.	_____	_____	_____
e. Read reports and related correspondence of internal audit staff (if any) and consider the possible effect of internal audit work and findings on scope of the audit.	_____	_____	_____
3. Discuss the following matters (and others as appropriate) with client personnel:			
a. Changes in key personnel.	_____	_____	_____
b. Significant accounting or reporting problems.	_____	_____	_____
c. Changes in accounting methods or accounting principles.	_____	_____	_____
d. Principle findings of internal auditors.	_____	_____	_____
e. Changes in information processing methods or technology.	_____	_____	_____
f. Disposition of prior year's management letter points.	_____	_____	_____

* As applicable

	<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.	_____	_____	_____

.02 B. Assigning Personnel to the Engagement

1. Prepare a time budget by audit area for the engagement to determine manpower requirements and to schedule fieldwork.	_____	_____	_____
2. Have the engagement partner approve the time budget prior to the beginning of fieldwork.	_____	_____	_____
3. Consider the following factors in achieving a balance of engagement manpower requirements, personnel skills, individual development, and utilization:			
a. Engagement size and complexity.	_____	_____	_____
b. Personnel availability.	_____	_____	_____
c. Special expertise required.	_____	_____	_____
d. Timing of the work performed.	_____	_____	_____
e. Continuity and periodic rotation of personnel.	_____	_____	_____
f. Opportunities for on-the-job training.	_____	_____	_____
4. Have the scheduling and staffing of the engagement approved by the partner with final responsibility for the engagement, so that the partner can consider the qualifications, experience, and training of personnel to be assigned.	_____	_____	_____

.03 C. Independence

1. If acting as principal auditor, obtain written confirmation of the independence of other firms engaged to perform segments of the audit.	_____	_____	_____
2. Review annual independence 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.

	<i>Done by (or "N/A")</i>	<i>Date</i>	<i>W/P Ref.*</i>
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).	_____	_____	_____
5. Evaluate the scope of other services being performed for the client, such as nonattest services, which may impair the firm's independence.	_____	_____	_____
.04 D. Knowledge of the Entity's Business			
1. Obtain an initial, overall understanding of the clients' operations by—			
a. Reviewing the prior years' working papers, permanent file, auditor's report, and financial statements.	_____	_____	_____
b. Reviewing any interim financial statements or reports for the current year, including filings with regulatory agencies; or, if such statement or reports have not been prepared, by scanning the general ledger (or trial balance) to determine whether the amounts and relationships appear reasonable in comparison with the prior years.	_____	_____	_____
c. Reviewing most recent management letters.	_____	_____	_____
d. Reviewing the client correspondence file.	_____	_____	_____
e. Obtaining copies of the minutes of meetings of stockholders, the board of directors, and relevant committees.	_____	_____	_____
f. Considering possible impact of nonaudit services rendered to client on the audit.	_____	_____	_____
2. Discuss the following matters with management:			
a. Changes in operations, including planned changes.	_____	_____	_____
b. Significant legal matters and contingencies.	_____	_____	_____
3. Obtain an understanding of the effect of laws, regulations, and ordinances having a direct and material effect on the financial statements, and if necessary prepare a list of such laws for the workpapers.	_____	_____	_____
4. Obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics such as the following:			
a. The type of business.	_____	_____	_____
b. Types of products and services.	_____	_____	_____
c. Capital structure.	_____	_____	_____
d. Related parties.	_____	_____	_____

* As applicable.

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

* As applicable.

	<i>Done by (or "N/A")</i>	<i>Date</i>	<i>W/P Ref.*</i>
c. Financial statements of other entities in the industry.	_____	_____	_____
d. Textbooks, periodicals, and individuals knowledgeable about the industry.	_____	_____	_____
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 each 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.	_____	_____	_____
.05 E. Assessing Auditability			
1. Assess the adequacy of the accounting records for the following factors:			
a. Transactions described in sufficient detail to permit appropriate classification in financial statements.	_____	_____	_____
b. Transactions described in a manner that permits the recording of monetary value in the financial statements.	_____	_____	_____
c. Accounting records include the period in which the transactions occurred to permit the recording of transactions in the appropriate accounting period.	_____	_____	_____

* As applicable.

	<u>Done by (or "N/A")</u>	<u>Date</u>	<u>W/P Ref.*</u>
2. Obtain sufficient knowledge of the design of the relevant controls pertaining to each of the five internal control components and whether they have been placed in operation. In completing this step, complete the "Internal Control" program at AAM section 5400, as appropriate.	_____	_____	_____
3. Document the understanding of the entity's five components of internal control obtained to plan the audit.	_____	_____	_____
4. Reform the following procedures regarding the integrity of management:			
a. Inquiries of local attorneys, bankers, and other business leaders as to the client's standing in the business community.	_____	_____	_____
b. A check of the client's credit rating.	_____	_____	_____
5. Document the matters listed above relating to the auditability of the entity in the workpapers, as deemed necessary.	_____	_____	_____

.06 F. Understanding With the Client/Engagement Letter

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. Management's responsibility for determining the appropriate disposition of financial statement misstatements aggregated by the auditor.	_____	_____	_____
j. A statement that the auditor may decline to issue a report if, for any reason, the auditor is unable to complete the audit.	_____	_____	_____
k. A statement that the audit is not designed to provide assurance on internal control or to identify reportable conditions.	_____	_____	_____
l. Provision for client's acceptance signature and date.	_____	_____	_____
m. Expression of thanks for being selected as auditors or to perform other services.	_____	_____	_____

* As applicable.

	<u>Done by (or "N/A")</u>	<u>Date</u>	<u>W/P Ref.*</u>
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.	_____	_____	_____
.07 G. Assessing Audit Risk and Materiality			
1. Determine a preliminary judgment about the dollar amount of misstatement that would be material to the financial statements.	_____	_____	_____
2. Relate that amount to tolerable error for specific account balances in planning audit procedures.	_____	_____	_____
3. Assess and document inherent risk and control risk to determine how much detection risk can be accepted while still restricting audit risk to an acceptably low level.	_____	_____	_____
4. Assess and document, by considering the understanding obtained of the internal control components and by considering all other matters influencing audit risk, the risk of material misstatement due to error, illegal acts, and other factors.	_____	_____	_____
5. Discuss among engagement personnel the risk of material misstatement due to fraud according to the guidelines presented in paragraphs 14–18 of SAS No. 99 (AU section 316.14–18).	_____	_____	_____
6. Consider the presence of fraud risk factors in the following categories:			
• Incentives/pressures to perpetrate fraud	_____	_____	_____
• Opportunities to carry out the fraud	_____	_____	_____
• Attitudes/rationalizations to justify a fraudulent action	_____	_____	_____

* As applicable.

	<u>Done by (or "N/A")</u>	<u>Date</u>	<u>W/P Ref.*</u>
7. Obtain information needed to identify risks of material misstatement by			
a. Inquiring of management and others within the entity about the risks of fraud and how they are addressed. (See paragraphs 20 through 27 of SAS No. 99 [AU section 316.20–.27].)	_____	_____	_____
b. Considering any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See paragraphs 28 through 30 of SAS No. 99 [AU section 316.28–.30].)	_____	_____	_____
c. Consider fraud risk factors. (See paragraphs 31 through 33 and the appendix of SAS No. 99 [AU section 316.31–.33 and .85].)	_____	_____	_____
d. Considering certain other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph 34 of SAS No. 99 [AU section 316.34].)	_____	_____	_____
8. Identify risks that may result in a material misstatement due to fraud			
a. Use information gathered (see paragraphs 19 through 34 of SAS No. 99 [AU section 316.19–.34]) to identify risk of material misstatements due to fraud	_____	_____	_____
b. Presume that improper revenue recognition is a fraud risk	_____	_____	_____
c. Consider the risk of management of override of controls	_____	_____	_____
9. Assess the identified risks after taking into account an evaluation of the entity's programs and controls that address identified risks of material misstatement due to fraud.	_____	_____	_____
10. Develop responses to the results of the assessment of the risks of material misstatement due to fraud in one of the following three ways:			
a. A response that has an overall effect on how the audit is conducted. (See paragraph 50 of SAS No. 99 [AU section 316.50].)	_____	_____	_____
b. A response involving the nature, timing and extent of procedures to be performed. (See paragraphs 51 through 56 of SAS No. 99 [AU section 316.51–.56].)	_____	_____	_____
c. A response to further address the risk of management override of controls. (See paragraphs 57 through 66 of SAS No. 99 [AU section 316.57–.66].)	_____	_____	_____
11. Document in the workpapers the following:			
a. The discussions among engagement personnel in planning the audit regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, including how and when the discussion occurred, the audit team members who participated, and the subject matter discussed.	_____	_____	_____

* As applicable.

	<u>Done by (or "N/A")</u>	<u>Date</u>	<u>W/P Ref.*</u>
b. The procedures performed to obtain information necessary to identify and assess the risks of material misstatement due to fraud.	_____	_____	_____
c. Specific risks of material misstatement due to fraud that were identified.	_____	_____	_____
d. If improper revenue recognition has not been identified as a risk of material misstatement due to fraud, the reasons supporting that conclusion.	_____	_____	_____
e. The results of procedures performed to further address the risk of management override of controls.	_____	_____	_____
f. Other conditions and analytical relationships that caused the auditor to believe that additional auditing procedures or other responses were required and any further responses the auditor concluded were appropriate, to address such risks or other conditions.	_____	_____	_____
12. 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.)	_____	_____	_____
13. Consider the risk of material misstatement (due to error, fraud, illegal acts, and other factors) assessment in determining:			
a. Overall audit strategy.	_____	_____	_____
b. The nature, timing, and extent of audit procedures.	_____	_____	_____
c. Staff assignments.	_____	_____	_____
d. Appropriate levels of supervision.	_____	_____	_____
.08 H. Assessment of Control Risk			
1. Assess control risk. In assessing control risk, complete the "Internal Control" program at AAM section 5400.	_____	_____	_____
2. Document conclusions about the control risk assessment, including the bases for assessing control risk at the maximum or below the maximum for financial statement assertions.	_____	_____	_____
3. In circumstances where electronic evidence is significant, reconsider the appropriateness of assessing control risk at the maximum and performing only substantive testing, given the usual dependency of competent electronic evidence on effective internal control.	_____	_____	_____
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.	_____	_____	_____

* As applicable.

<i>Done by (or "N/A")</i>	<i>Date</i>	<i>W/P Ref.*</i>
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b. Perform tests of controls to evaluate the effectiveness of such controls.		
--	--	--

5. If a further reduction in the assessed level of control risk is desired for some financial statement assertions, perform additional tests of relevant controls.		
--	--	--

.09 I. Illegal Acts

1. Consider the following matters in the assessment of risk that the entity has not complied with laws and regulations that have a direct and material effect on the determination of financial statement amounts:		
--	--	--

a. The client's policy, if any, relative to the prevention of illegal acts.		
---	--	--

b. Management's understanding of the requirements of laws and regulations pertinent to audit objectives.		
--	--	--

c. The nature and extent of noncompliance noted in prior audits.		
--	--	--

d. Internal control components designed to give management reasonable assurance that the entity complies with those laws and regulations.		
---	--	--

.10 J. Analytical Procedures

1. Use analytical procedures which focus on:		
--	--	--

a. Enhancing the auditor's understanding of the client's business and the transactions and events that have accrued since the last audit date.		
--	--	--

b. Identifying areas that may represent specific risks relevant to the audit.		
---	--	--

.11 K. Audit Strategies and the Audit Program

1. Use the information obtained or developed concerning materiality, internal control, the results of preliminary analytical procedures, risk assessments, and other matters used in assessing audit risk to plan:		
--	--	--

a. The overall strategy for the conduct and scope of the audit.		
---	--	--

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 listing below contains example risk factors for small, privately-owned businesses. If used, this memory jogger should be tailored for the particular client being audited. Identified or possible risk factors should be added to the list. An auditor may also decide to remove the example factors from the list, based on the circumstances. In any event, be sure to consider fraud risk factors that relate to fraudulent financial reporting and misappropriation of assets in every related category presented below. 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. 99 (AU section 316) does not require an auditor to use a memory jogger or checklist of fraud risk factors.

Part 1—Fraudulent Financial Reporting

<i>Fraud Risk Factors Considered</i>	<i>Present at Client?</i>	<i>Audit Response Developed?</i> ¹	<i>Audit Response Documented? (W/P Ref.)</i> ²	<i>Additional Information</i>
A. Incentives/Pressures				
<i>a.</i> Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by): <ol style="list-style-type: none"> (1) High degree of competition or market saturation, accompanied by declining margins. (2) New accounting, statutory, or regulatory requirements. (3) Significant declines in customer demand and increasing business failures in either the industry or the economy in which the entity operates. (4) High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates. (5) Operating losses making the threat of bankruptcy or foreclosure, imminent. (6) Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth. (7) Rapid growth or unusual profitability especially compared to that of other companies in the same industry. 				
<i>b.</i> Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following: <ol style="list-style-type: none"> (1) Need to obtain additional debt or equity financing to stay competitive, including financing of major research and development or capital expenditures. (2) Marginal ability to meet debt repayment or other debt covenant requirements. 				
<i>c.</i> Management's personal net wealth is threatened by the entity's financial performance arising from the following: <ol style="list-style-type: none"> (1) Heavy concentrations of their personal net worth in the entity. 				

<i>Fraud Risk Factors Considered</i>	<i>Present at Client?</i>	<i>Audit Response Developed?¹</i>	<i>Audit Response Documented? (W/P Ref.)²</i>	<i>Additional Information</i>
(2) Personal guarantees of debt of the entity that are significant to their personal net worth.				
(3) Adverse consequences on significant matters if <i>good</i> financial results are reported. Specific examples include management's motivation to inappropriately reduce income taxes, to defraud a divorced spouse or a partner of his or her share of the profits or assets of a business, or to convince a judge or arbitrator that the business in dispute is not capable of providing adequate cash flow. Keep in mind that you are not required to plan your audit to discover personal information (e.g., marital status) of the owner-manager. However, if you become aware of such information, you should consider it in your assessment of risk of material misstatement due to fraud.				
d. There is excessive pressure on management or operating personnel to meet financial targets set by the owner, including sales or profitability incentive goals.				
B. Opportunities				
a. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:				
(1) Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.				
(2) Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.				
(3) Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult "substance over form" questions.				
b. There is a complex or unstable organizational structure as evidenced by the following:				
(1) Difficulty in determining the organization or individuals that have controlling interest in the entity.				
(2) Overly complex organizational structure involving unusual legal entities or managerial lines of authority.				
(3) High turnover of senior management or counsel.				
c. Internal control components are deficient as a result of the following:				
(1) Inadequate monitoring of controls, including automated controls.				
(2) High turnover rates or employment of ineffective accounting staff.				
(3) Ineffective accounting and information systems including situations involving reportable conditions.				

<i>Fraud Risk Factors Considered</i>	<i>Present at Client?</i>	<i>Audit Response Developed?¹</i>	<i>Audit Response Documented? (W/P Ref.)²</i>	<i>Additional Information</i>
C. Attitudes/ Rationalizations				
1. A failure for management to display and communicate an appropriate attitude regarding internal control and the financial reporting process.				
2. Ineffective communication and support of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards.				
3. Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates.				
4. Known history of violations or claims against the entity, its owner or senior management alleging fraud or violations of laws and regulations.				
5. A practice by management of committing to, creditors, and other third parties to achieve aggressive or unrealistic forecasts.				
6. Management failing to correct known reportable conditions on a timely basis.				
7. An interest by management in employing inappropriate means to minimize reported earnings for tax motivated reasons.				
8. Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.				
9. The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:				
a. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.				
b. Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report.				
c. Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee.				
d. Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of audit personnel assigned to the engagement.				

Part 2—Misappropriation of Assets

<i>Fraud Risk Factors Considered</i>		<i>Present at Client?</i>	<i>Audit Response Developed?¹</i>	<i>Audit Response Documented? (W/P Ref.)²</i>	<i>Additional Information</i>
A. Incentives/Pressures					
a.	Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.				
b.	Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:				
	(1) Known or anticipated future layoffs.				
	(2) Promotions, compensation, or other rewards inconsistent with expectations.				
B. Opportunities					
a.	Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:				
	(1) Large amounts of cash on hand or processed.				
	(2) Company issued credit cards.				
	(3) Inventory items that are small in size, of high value, or in high demand.				
	(4) Easily convertible assets.				
	(5) Fixed assets, that, are small in size, marketable, or lacking observable identification of ownership.				
b.	Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:				
	(1) Inadequate segregation of duties or independent checks. Inadequate segregation of duties is quite often understandable in a small business environment in that it's a function of the entity's size. However, you should consider it in conjunction with other risk factors and with mitigating controls.				
	(2) Inadequate management oversight of employees responsible for assets.				

<i>Fraud Risk Factors Considered</i>	<i>Present at Client?</i>	<i>Audit Response Developed?¹</i>	<i>Audit Response Documented? (W/P Ref.)²</i>	<i>Additional Information</i>
(3) Inadequate job applicant screening of employees with access to assets.				
(4) Inadequate record keeping with respect to assets.				
(5) Inadequate system of authorization and approval of transactions (for example, in purchasing).				
(6) Inadequate physical safeguards over cash, investments, inventory, or fixed assets.				
(7) Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.				
(8) Lack of mandatory vacations for employees performing key control functions.				
(9) Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.				
(10) Inadequate access controls over automated records.				
C. Attitudes/Rationalizations				
1. Disregard for the need for monitoring or reducing risks related to misappropriations of assets.				
2. Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.				
3. Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee.				
4. Changes in behavior or lifestyle that may indicate assets have been misappropriated.				

[The next page is 3381.]

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

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

.02

[illegible]

.03

Audit Time Analysis (Short Form)

	Client		Year Ended		Actual Daily Hours		Total	Next Year's Budget				
	Prior Years	Budgeted Hours	Week Beginning									
Administration												
Accounting systems review												
Confirmations												
Permanent file												
Client advisory comments												
Report preparation												
Tax returns												
Initial review												
Overall review												
Detailed review												
Tax accrual review												
Trial balance												
Cash												
Receivables												
Inventories												
Other assets												
Liabilities												
Equity												
Operating accounts												
Totals												
Accountants												
In-charge												
Totals												

.04

Audit Time Analysis (Long Form)

	Prior Years		Client		Year Ended							Total	Next Year's Budget	
			Budgeted Hours	Week Beginning	Actual Daily Hours									
Administration														
Client conferences														
Planning and scheduling														
Staff supervision														
Accounting systems review														
Internal control														
EDP installation														
General ledger														
Cash														
Sales														
Voucher register														
Payroll														
Journal entries														
Confirmations														
Permanent file														
Client advisory comments														
Report preparation														
Financial statements														
Footnotes														
Tax return preparation														
Review														
Initial review														
Overall review														
Detailed review														
Tax accrual review														
Subtotal to next page														

.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, 20XX.

We will audit the balance sheet of Civil War Antiques, Inc. as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them.

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.¹

¹ Some practitioners prefer to include in an engagement letter a clause that would indemnify them against knowing management misrepresentations in jurisdictions where such clauses are permitted. Ethics 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 companies also should consider the applicable Securities and Exchange Commission rules on independence before including an indemnification clause in an engagement letter.

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 (a "representation letter") from you about the financial statements and related matters.

The Company's management is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

As part of our engagement for the year ending December 31, 20XX, we will review the federal and state income tax returns for Civil War Antiques, Inc. Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

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.²

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

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

² This paragraph is optional depending upon the nature of the engagement

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

[Engagement Partner's Signature]

Accepted and agreed to:

[Client Representative's Signature]

[Title]

[Date]

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

RON TRACY & ASSOCIATES

Certified Public Accountants

[Date]

Mr. Joshua Snyder
Lawnmowers & Snowblowers Unlimited
731 Nathan Road
Hatville, NJ 00000

Dear Mr. Snyder:

This letter confirms our understanding of the services we will provide to Lawnmowers & Snowblowers Unlimited for the year ended December 31, 20XX.

We will audit the balance sheet of Lawnmowers & Snowblowers Unlimited as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them.

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.¹

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

¹ Some practitioners prefer to include in an engagement letter a clause that would indemnify them against knowing management misrepresentations in jurisdictions where such clauses are permitted. Ethics 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 companies also should consider the applicable Securities and Exchange Commission rules on independence before including an indemnification clause in an engagement letter.

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.

The Company's management is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

As part of our engagement for the year ending December 31, 20XX, 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.²

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

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

Sincerely,

RON TRACY & ASSOCIATES

[Engagement Partner's Signature]

Accepted and agreed to:

[Client Representative's Signature]

[Title]

[Date]

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

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

MACARTHUR & KENNEY, CPA'S

Certified Public Accountants

[Date]

Mr. James Melakon, Treasurer
Nimbus Country Club
64 Vasily Road
Velikiye Luki, Ohio 10000

Dear Mr. Melakon:

As we agreed in our original engagement letter dated [date] we are notifying you that our audit of your December 31, 20XX financial statements requires additional procedures.

We have found that certain guest checks are held for only three months after they are paid. Thus, a substantial number of guest checks are not available for examination. Fortunately, your internal control activities allow us to use alternative procedures to satisfy ourselves on this part of the audit. However, this will require substantially more time than examining guest checks.

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

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

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

Very truly yours,

MACARTHUR & KENNEY, CPA'S

[Engagement Partner's Signature]

Accepted and agreed to:

[Client Representative's Signature]

[Title]

[Date]

.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, 20XX letter described our present engagement as an audit for the purpose of expressing an opinion on the financial statements based on our audit. This letter is to inform you that because of the circumstances described below, we will be required to qualify our opinion on these statements.

As you know, the Internal Revenue Service has proposed total income tax assessments of approximately \$XXX,XXX for the three fiscal years ended December 31, 20XX. Your tax counsel has advised us that although you have a defensible position and will protest the assessments, counsel cannot offer an opinion as to your ultimate liability. No provision for this assessment or any portion of it is included in your December 31, 20XX financial statements, nor do you feel any is necessary.

Due to an inability to obtain sufficient evidential matter to support your assertions regarding the tax assessment situation described above, we will be unable to express an unqualified opinion. Our report will state the reasons for the qualification of our opinion.

You and your tax counsel have advised that you will inform us of any new developments in the proposed assessment before our report is issued so that we may consider their effect on your financial statements and on our report.

Sincerely,

GEROW, COLLINS & PATCH

[Engagement Partner's Signature]

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

.06 SEC Engagement: Initial Registration, Form S-1

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, 20X1 and 20X0, 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, 20X1, which will be included in a Form S-1,¹ 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.²

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

¹ This should be modified to agree with the particular form to be filed.

² Some practitioners prefer to include in an engagement letter a clause that would indemnify them against knowing management misrepresentations in jurisdictions where such clauses are permitted. Ethics Ruling No. 94 under AICPA Rule 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 companies also should consider the applicable Securities and Exchange Commission rules on independence before including an indemnification clause in an engagement letter.

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.

The Company's management is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

We will also fulfill the portion of the underwriter's agreement directed to the independent accountants, provided the requirements are within the purview of Statement on Auditing Standards No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (as amended by Statement on Auditing Standards No. 76), issued by the American Institute of Certified Public Accountants, and provided the material can properly be reported on by accountants pursuant to that Statement. In this regard, we require a copy of the tentative underwriting contract as soon as it is available.

Subsequent to issuance of our auditor's report, we will perform certain procedures required by Statement on Auditing Standards No. 37, *Filings Under Federal Securities Statutes*, issued by the American Institute of Certified Public Accountants, regarding execution of consent letters required for certain SEC filings. In connection therewith, all printer's proofs of reports to be filed with the Securities and Exchange Commission are to be submitted to us for review. This requirement extends to the entire registration statement and all other material that accompanies the financial statements.

As part of our engagement for the years ending December 31, 20X0 and 20X1, 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.³

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.

³ This paragraph is optional depending upon the nature of the engagement.

Sincerely,

SHERIDAN, CUSTER, AND STUART, CPAs

[Engagement Partner's Signature]

Accepted and agreed to:

[Client Representative's Signature]

[Title]

[Date]

.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, 20XX
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, 20XX, 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, 20XX. 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. Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
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, 20XX and statements of income, retained earnings, shareholders' equity, and cash flows for year ended March 31, 20XX
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, 20XX (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

[*Salutation*]

This will confirm our understanding of the arrangement for our audit of the financial statements of James and Jane Person for the [period] ended [date].

We will audit 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 on them. The financial statements are the responsibility of James and Jane Person. You are responsible for establishing and maintaining effective internal control over financial reporting, making all financial records and related information available for audit, and for identifying and ensuring compliance with the laws and regulations applicable to your activities.

You are responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements we have aggregated during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.*

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable 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.¹ Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. 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.

The 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 you are aware of any reportable conditions which come to our attention.

At the conclusion of our audit, you will provide us with a letter that confirms certain representations made during the audit.

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

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

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

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

* SAS No. 89, *Audit Adjustments*, among other matters, amends SAS No. 83, *Establishing an Understanding With The Client* (AU section 310), to add this new item to the list of matters generally addressed in the understanding with the client. SAS No. 89 is effective for audits of financial statements for periods beginning on or after December 15, 1999, with earlier adoption permitted.

¹ SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU section 316), describes the auditor's responsibilities to plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free of material misstatement, whether caused by error or fraud, and provides guidance on what should be done to meet those responsibilities

Sincerely yours,

(Signature of accountant)

Acknowledged:

(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 perform procedures to understand how internal controls are designed and determine whether they have been placed in operation. In obtaining this understanding, the auditor should consider how an entity’s use of information technology (IT) and manual procedures, may affect controls relevant to the audit. Then the auditor should assess control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.

.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 tests of controls, when applicable.
- 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 determine whether they have been placed in operation, you should develop an 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 level.*¹ This will result in a primarily substantive approach to auditing the assertion. When a significant amount of information supporting one or more financial statement assertions is electronically initiated, recorded, processed, or reported (especially when evidence exists only in electronic form), the auditor may determine that it is not possible to assess control risk at the maximum and design effective substantive tests that by themselves would provide sufficient evidence that the assertions are not materially misstated. In those cases, additional tests to determine the operating effectiveness of controls surrounding the electronic environment are necessary.

¹ The term *maximum level* means the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity’s internal control.

- *Control risk below the maximum level.* This will require additional tests to determine the operating effectiveness of specified controls, but in return, you will be able to modify the nature, timing, and extent of substantive audit procedures.

.06 AAM section 3125 provides a more detailed description of how to consider internal control at the planning phase of an audit.

.07 The following sections provide additional guidance on how you should consider internal control.

- *AAM section 4200—Internal Control Framework.* This section provides more detail on the internal control framework described in SAS No. 55 (AU section 319), as amended.
- *AAM section 4300—Illustrative Internal Control Forms—Small Business.* The forms in this section serve two purposes: (1) to help you perform the procedures necessary to understand internal control, and (2) to document that understanding. This section is to be used for small business entities.
- *AAM section 4400—Illustrative Internal Control Forms—Medium to Large Business.* These forms are similar to the ones provided in AAM section 4300, except geared to medium to large businesses.
- *AAM section 4500—Flowcharting.* This section provides examples of how you might document your understanding of internal control using flowcharting techniques.
- *AAM section 4600—Assessing Control Risk Below the Maximum.* This section provides guidance on the procedures to be performed when you plan a control risk assessment below the maximum for a specific assertion.

[The next page is 4201.]

AAM Section 4200

Internal Control Framework

Introduction

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

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

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

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

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

.04 Although an entity's internal control addresses objectives referred to in AAM section 4200.02, not all of these objectives and related controls are relevant to an effective 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 because these controls are not relevant to the audit, you are not required to do so.

.07 However, if controls relating to operations and compliance objectives pertain to data 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 access controls, such as passwords that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, controls to prevent the excess use of materials in production generally are not relevant to a financial statement audit. 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. Controls relevant to the audit are those that individually or in combination with others are likely to prevent or detect material misstatements in financial statement assertions. Such controls may exist in any of the five components.

.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, whether individually or in combination with other controls, affect financial statement assertions relating to cash.*

Effect of Information Technology on Internal Control

.14 An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. For example, an entity may use IT as part of discrete systems that support only particular business units, functions, or activities, such as a unique accounts receivable system for a particular business unit or a system that controls the operation of factory equipment. Alternatively, an entity may have complex, highly integrated systems that share data and that are used to support all aspects of the entity's financial reporting, operations, and compliance objectives.

.15 The use of IT also affects the fundamental manner in which transactions are initiated, recorded, processed, and reported. In a manual system, an entity uses manual procedures and records in paper format (for example, individuals may manually record sales orders on paper forms or journals, authorize credit, prepare shipping reports and invoices, and maintain accounts receivable records). Controls in such a system also are manual and may include such procedures as approvals and reviews of activities, and reconciliations and follow-up of reconciling items. Alternatively, an entity may have information systems that use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace such paper documents as purchase orders, invoices, shipping documents, and related accounting records. Controls in systems that use IT consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. An entity's mix of manual and automated controls varies with the nature and complexity of the entity's use of IT.

.16 IT provides potential benefits of effectiveness and efficiency for an entity's internal control because it enables an entity to—

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data.
- Enhance the timeliness, availability, and accuracy of information.
- Facilitate the additional analysis of information.
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures.
- Reduce the risk that controls will be circumvented.
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

.17 IT also poses specific risks to an entity's internal control, including—

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions.
- Unauthorized changes to data in master files.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data.

.18 The extent and nature of these risks to internal control vary depending on the nature and characteristics of the entity's information system. For example, multiple users, either external or internal, may access a common database of information that affects financial reporting. In such circumstances, a lack of control at a single user entry point might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data. When IT personnel or users are given, or can gain, access privileges beyond those necessary to perform their assigned duties, a breakdown in segregation of duties can occur. This could result in unauthorized transactions or changes to programs or data that affect the financial statements. Therefore, the nature and characteristics of an entity's use of IT in its information system affect the entity's internal control.

.19 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 information technology (IT) is used to process significant accounting information.
- Understand control activities for significant account balances or transaction cycles.
- Assess the risk of management override and lack of segregation of duties.

Focus on the Small Business Entity

.20 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.

.21 This section provides some guidance for the audits of medium to large businesses.

Controls With a Pervasive Effect on the Organization

.22 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

.23 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.

.24 ***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.

.25 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.

.26 For management's integrity and ethical values to have a positive effect 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.

.27 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.

.28 *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.

.29 *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.*

.30 ***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.*

.31 *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.*

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

.33 *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.*

.34 ***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.*

.35 *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.*

.36 ***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

.37 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.

.38 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.

.39 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.

.40 *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.*

.41 *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.*

.42 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.

.43 **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.

.44 *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.

.45 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.

.46 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

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

.48 **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.

.49 Risks relevant to financial reporting include events and circumstances that may adversely affect the company's ability to initiate, record, process, 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.

.50 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 business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

.51 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.

.52 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, whether automated or manual, have various objectives and are applied at various organizational and functional levels.

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

- *Performance reviews.* These control activities include reviews of actual performance versus budgets, forecasts, and prior-period performance. They may also involve relating different sets of data (for example, operating or financial) to one another, together with analyses of the relationships, investigating unusual relationships and taking corrective action. Performance reviews may also include a review of functional or activity performance.
- *Information processing.* A variety of controls are performed to check accuracy, completeness, and authorization of transactions. The two broad groupings of information systems control activities are application controls and general controls. Application controls apply to the processing of individual applications. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. General controls commonly include controls over data center and network operations; system software acquisition and maintenance; access security; and application system acquisition, development, and maintenance. These controls apply to mainframe, miniframe, and end-user environments. Examples of such general controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail. These controls are discussed in more detail in AAM section 4200.76–.80.
- *Physical controls.* These activities encompass the physical security of assets, including adequate safeguards over access to assets and records such as secured facilities and authorization for access to computer programs and data files and periodic counting and comparison with amounts shown on control records. The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation. For example, these controls would ordinarily not be relevant when inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, the physical security controls would be relevant to the audit.
- *Segregation of duties.* Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of his or her duties. Segregation of duties is often a problem for small business entities. See AAM section 4200.118–.126 for further discussion and guidance.

.54 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.

.55 The auditor should obtain an understanding of how IT affects control activities that are relevant to planning the audit. Some entities and auditors may view the IT control activities in terms of application controls and general controls. Application controls apply to the processing of individual applications. Accordingly, application controls relate to the use of IT to initiate, record, process, and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, numerical sequence checks, and manual follow-up of exception reports.

.56 Application controls may be performed by IT (for example, automated reconciliation of subsystems) or by individuals. When application controls are performed by people interacting with IT, they may be referred to as user controls. The effectiveness of user controls, such as reviews of computer-produced exception reports or other information produced by IT, may depend on the accuracy of the information produced. For example, a user may review an exception report to identify credit sales over a customer's authorized credit limit without performing procedures to verify its accuracy. In such cases, the effectiveness of the user control (that is, the review of the exception report) depends on both the effectiveness of the user review and the accuracy of the information in the report produced by IT.

.57 General controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General controls commonly include controls over data center and network operations; system software acquisition and maintenance; access security; and application system acquisition, development, and maintenance.

.58 The use of IT affects the way that control activities are implemented. For example, when IT is used in an information system, segregation of duties often is achieved by implementing security controls.

.59 **Information and Communication.** An information system consists of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data. Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual. Many information systems make extensive use of information technology. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Transactions may be initiated manually or automatically by programmed procedures. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization, and reconciliation, whether performed by automated or manual procedures. Reporting relates to the preparation of financial reports as well as other information, in electronic or printed format, that the entity uses in monitoring and other functions.

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

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.

- Measure the value of transactions in a manner that permits recording of their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

.61 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 4200.101–.119 for additional guidance.

.62 Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels help ensure that exceptions are reported and acted on. Communication takes such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

.63 The auditor should obtain sufficient knowledge of the information system relevant to financial reporting to understand—

- The classes of transactions in the entity's operations that are significant to the financial statements.
- The procedures, both automated and manual, by which transactions are initiated, recorded, processed, and reported from their occurrence to their inclusion in the financial statements.
- The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, recording, processing, and reporting transactions.
- How the information system captures other events and conditions that are significant to the financial statements.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

.64 When IT is used to initiate, record, process, or report transactions or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for significant accounts or may be critical to the effective functioning of manual controls that depend on IT.

.65 In obtaining an understanding of the financial reporting process, the auditor should understand the automated and manual procedures an entity uses to prepare financial statements and related disclosures, and how misstatements may occur. Such procedures include—

- *The procedures used to enter transaction totals into the general ledger.* In some information systems, IT may be used to automatically transfer such information from transaction processing systems to general ledger or financial reporting systems. The automated processes and controls in such systems may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or financial reporting system. Furthermore, in planning the audit, the auditor should be aware that when IT is used to automatically transfer information there may be little or no visible evidence of such intervention in the information systems.

- *The procedures used to initiate, record, and process journal entries in the general ledger.* An entity's financial reporting process used to prepare the financial statements typically includes the use of standard journal entries that are required on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements, or to record accounting estimates that are periodically made by management such as changes in the estimate of uncollectible accounts receivable. An entity's financial reporting process also includes the use of nonstandard journal entries to record nonrecurring or unusual transactions or adjustments such as a business combination or disposal, or a nonrecurring estimate such as an asset impairment. In manual, paper-based general ledger systems, such journal entries may be identified through inspection of ledgers, journals, and supporting documentation. However, when IT is used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may be more difficult to identify through physical inspection of printed documents.
- *Other procedures used to record recurring and nonrecurring adjustments to the financial statements.* These are procedures that are not reflected in formal journal entries, such as consolidating adjustments, report combinations, and reclassifications.

.66 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.

.67 Examples of ongoing monitoring activities include the following:

- Management reviews of data produced by the entity's information system. Managers are in touch with operations and may question reports that differ significantly from their knowledge of operations. However, management should have a basis for believing the data are accurate. If errors exist in the information, management may make incorrect conclusions from its monitoring activities.
- Communications from external parties corroborate internally generated information or indicate problems. Customers implicitly corroborate billing data by paying their invoices. Conversely, customer complaints about billings could indicate system deficiencies in the processing of sales transactions. Similarly, bankers, regulators or other outside parties may communicate with the company on matters of accounting significance.
- External auditors regularly provide recommendations on the way internal control can be strengthened. Auditors may identify potential weaknesses and make recommendations to management for corrective action.
- Employees may be required to "sign off" to evidence the performance of critical control functions. The sign-off allows management to monitor the performance of these control functions.

Application to Medium and Large Businesses

.68 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

.69 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.

.70 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.

.71 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

.72 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.

.73 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).

.74 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

.75 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

.76 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.

.77 *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.*

.78 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

.79 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, random-access memory (RAM), or hard-disk storage.

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

.81 *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?*

.82 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.

.83 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

.84 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.

.85 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

.86 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.

.87 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.

.88 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

.89 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, *Service Organizations*, as amended by SAS Nos. 88 and 98, *Omnibus Statement on Auditing Standards—2002* (AU section 324).

.90 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. When the service organization initiates, executes, and does the accounting processing of the user organization's transactions, it may not be practicable for the user organization to implement effective controls for those transactions.

.91 *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

.92 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.

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

.94 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.

.95 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.

.96 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

.97 *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.

.98 *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.

.99 *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.

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

Obtaining an Understanding of Significant Account Balances and Transaction Cycles

.101 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.

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

- The procedures, both automated and manual, by which transactions are initiated, recorded, processed, and reported from their occurrence to their inclusion in the financial statements.

- The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, recording, processing, and reporting transactions.
- How the information system captures other events and conditions that are significant to the financial statements.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

.103 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.

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

.105 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.

.106 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.

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

.108 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.

.109 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.

.110 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.

.111 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.

.112 *Accounting Records, Supporting Information, 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

.113 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.

.114 *At Jones Grocery, the sales analysis report described in AAM section 4200.104 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.*

.115 *Other Significant Events and Conditions.* You should understand how the entity's information system captures other events and conditions that are significant to the financial statements. This might involve, for example, nonrecurring or unusual transactions or adjustments and nonrecurring estimates.

.116 *A broken water line, which is an uninsured risk, spoiled a large amount of produce and dry goods in one of the Jones Grocery stores. Based on a list of the lost inventory provided by the store manager, Mrs. Jones recorded a large spoilage loss.*

.117 *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

.118 Small businesses are typically characterized by—

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

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

.120 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.

.121 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.

.122 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.

.123 Management *override* should be distinguished from management *intervention*. Management *intervention* is discussed in AAM section 4200.27 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.

.124 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.

.125 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.

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

Assessing Internal Control Strengths and Weaknesses

.127 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.

.128 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.

.129 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.

.130 If you determine the entity is unauditably, you should consider withdrawing from the engagement.

[The next page is 4301.]

AAM Section 4300

Illustrative Internal Control Forms—Small Business

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

Instructions

.02 The forms in AAM sections 4310 and 4320 may be used on all small business audit engagements. Small businesses are typically characterized by—

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

.03 If your client does not have the characteristics of a small business, you should consider completing the internal control forms for medium to large businesses located in AAM section 4400.

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

.05 These forms should be used in conjunction with other forms in certain circumstances:

- *Control Environment Checklist—Small Business Computer Applications* [AAM section 4310]. To be used whenever the client uses microcomputers or outside service organizations to process significant accounting information.
- *Financial Reporting Information Systems and Controls Checklist* [AAM section 4320]. To be used for each significant account and transactions cycle.

.06 These forms are appropriate whenever you plan a primarily substantive audit approach (see paragraph .08 below). That is, their completion generally results in control risk being assessed at or slightly below the maximum for all assertions related to account balances and transactions.

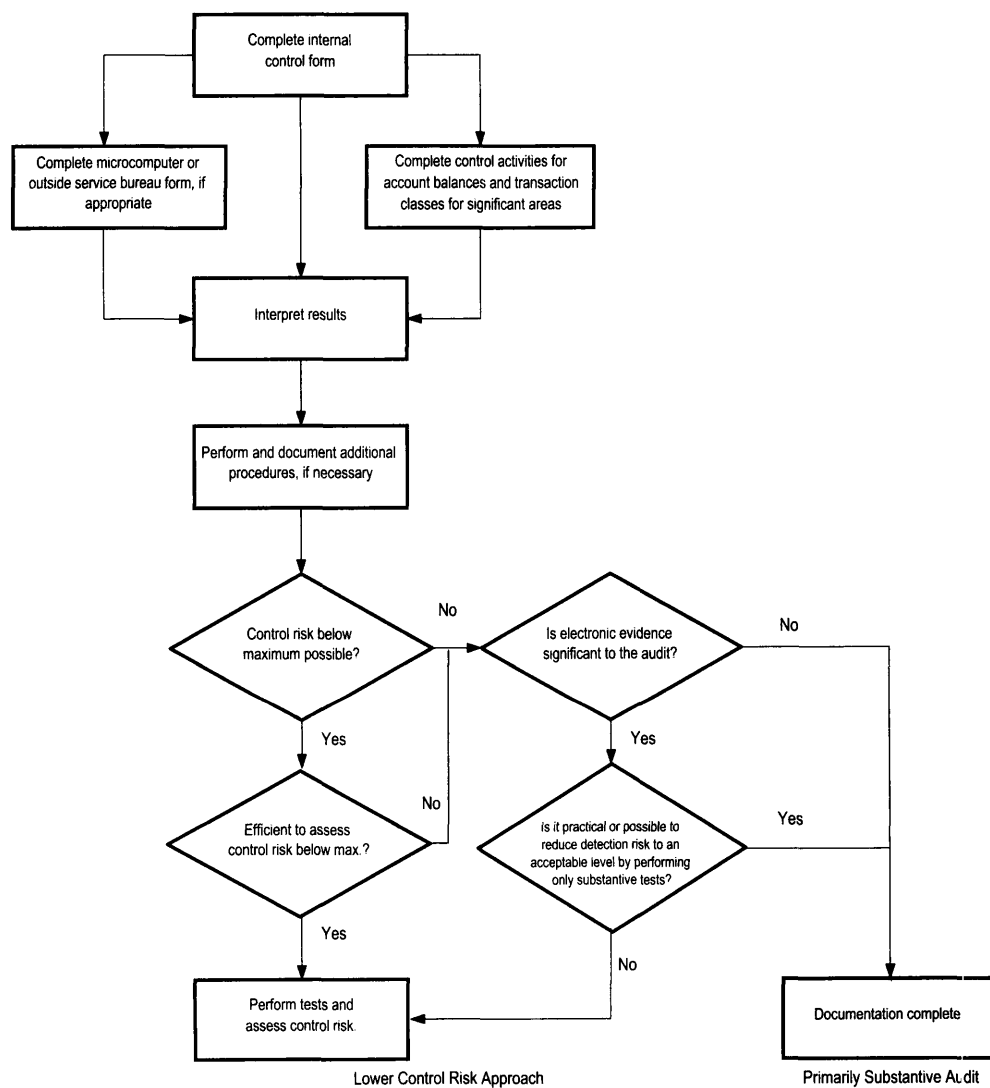
.07 If you plan a lower control risk assessment for certain assertions you are required to—

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

.08 In situations where significant 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 especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form.) 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>
A. Control Environment Factors					
<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.	_____	_____	_____	_____	_____
<i>Management's Philosophy and Operating Style</i>					
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.	_____	_____	_____	_____	_____
<i>Organizational Structure</i>					
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.	_____	_____	_____	_____	_____
<i>Assignment of Authority and Responsibility</i>					
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.	_____	_____	_____	_____	_____
<i>Human Resource Policies and Practices</i>					
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. Other Internal Control Components With a Pervasive Effect on the Organization					
<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.	_____	_____	_____	_____	_____
General Control Activities					
9. The entity prepares operating budgets and cash flow projections.	_____	_____	_____	_____	_____
10. Operating budgets and projections lend themselves to effective comparisons with actual results.	_____	_____	_____	_____	_____
11. Significant variances between budgeted or projected amounts and actual results are reviewed and explained.	_____	_____	_____	_____	_____
12. The company has adequate safekeeping facilities for custody of the accounting records such as fireproof storage areas and restricted access cabinets.	_____	_____	_____	_____	_____
13. The entity has a suitable record retention plan.	_____	_____	_____	_____	_____
14. Periodically, personnel compare counts of assets to amounts shown on control records.	_____	_____	_____	_____	_____
15. There is adequate segregation of duties among those responsible for authorizing transactions, recording transactions, and maintaining custody of assets.	_____	_____	_____	_____	_____
Information and Communication					
16. Management receives the information they need to carry out their responsibilities.	_____	_____	_____	_____	_____
17. Information is provided at the right level of detail for different levels of management.	_____	_____	_____	_____	_____
18. Information is available on a timely basis.	_____	_____	_____	_____	_____

	<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.	_____	_____	_____	_____	_____
Monitoring					
20. Customer complaints about billings are investigated for their underlying causes.	_____	_____	_____	_____	_____
21. Communications from bankers, regulators, or other outside parties are monitored for items of accounting significance.	_____	_____	_____	_____	_____
22. Management responds appropriately to auditor recommendations on ways to strengthen internal controls.	_____	_____	_____	_____	_____
23. Employees are required to "sign off" to evidence the performance of critical control functions.	_____	_____	_____	_____	_____

II. Determine Other Areas for Evaluation

The completion of section I of this form is the first of several forms that may be used to document your understanding of internal control sufficiently to plan a primarily substantive audit. It is important to remember that in entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of the controls surrounding the electronic environment may not be enough. This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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>
Microcomputers or Outside Service Bureaus			
1. The company uses microcomputers or outside computer service bureaus to process significant accounting information.	_____	_____	
If "yes," the Control Environment Checklist—Small Business Computer Applications can be found at—			_____

Significant Account Balances and Transaction Cycles

2. The following account balances or transaction cycles are significant to the company's financial statements.			
a. Revenue cycle, including sales, accounts receivable, or cash receipts. (Normally considered significant for most small businesses.)	_____	_____	
If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—			_____

	<i>No</i>	<i>Yes</i>	<i>W/P Ref.</i>
b. Purchasing cycle, including purchasing, accounts payable, or cash disbursements. (Normally considered significant for most small businesses.)	_____	_____	_____
If “yes,” the related Financial Reporting Information Systems and Controls Checklist can be found at—			_____
c. Inventory, including inventory and cost of sales.	_____	_____	_____
If “yes,” the related Financial Reporting Information Systems and Controls Checklist can be found at—			_____
d. Financing, including investments and debt.	_____	_____	_____
If “yes,” the related Financial Reporting Information Systems and Controls Checklist can be found at—			_____
e. Property, plant, and equipment, including fixed assets and depreciation.	_____	_____	_____
If “yes,” the related Financial Reporting Information Systems and Controls Checklist can be found at—			_____
f. Payroll.	_____	_____	_____
If “yes,” the related Financial Reporting Information Systems and Controls checklist can be found at —			_____

III. Assess Segregation of Duties

An appropriate segregation of duties often appears to present difficulties in small business organizations, at least on the surface. Even companies that have only a few employees, however, can usually parcel out their responsibilities to achieve the necessary checks and balances. But if that is not possible—as may occasionally be the case—direct oversight of the incompatible activities by the owner-manager can provide the necessary control. For example, it is not uncommon, where there is a risk of improper cash payments, for the owner-manager to be named the only authorized check signer, or to require that monthly bank statements be delivered unopened directly to him or her for review of paid checks. In the space provided below, assess the segregation of duties for the company based on the completion of sections I and II of this form. Your comments should address—

- The person with incompatible responsibilities and the nature of those responsibilities.
- Any mitigating factors or controls, such as direct management oversight.
- The risk that material misstatements might occur as a result of a lack of segregation of duties and the type of those misstatements.
- How substantive procedures will be designed to limit the risk of those misstatements to an acceptable level.

IV. Assess the Risk of Management Override

Even in effectively controlled entities—those with generally high levels of integrity and control consciousness—a manager might be able to override controls. The term “management override” means—

Overruling prescribed policies or procedures for *illegitimate* purposes with the intent of personal gain or enhanced presentation of an entity’s financial condition or compliance status.

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

Management override is different from management intervention, which is the overrule of prescribed policies or procedures for legitimate purposes. For example, management intervention is usually necessary to deal with non-recurring and non-standard transactions or events that otherwise might be handled by the system.

In the space below, assess the risk of management *override* for this company. You should consider the risk that management override possibilities exist, the risk that management will take advantage of those possibilities, and any evidence that management has engaged in override practices. If the risk of management override is greater than low, indicate how planned audit procedures will reduce this risk to an acceptable level.

V. Interpret Results

You should consider the *collective* effect of the strengths and weaknesses in various control components. Management’s strengths and weaknesses may have a pervasive effect on internal control. For example, owner-manager controls may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by the owner-manager to overstate earnings.

A. Areas That May Allow for Control Risk to Be Assessed Below the Maximum

Based on the completion of sections I through IV of this form you may have become aware of certain accounts, transactions and assertions where it may be possible and efficient to plan a control risk assessment below the maximum. In the area below, document those accounts, transactions, and assertions and the related tests of controls.

<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.
- How substantive procedures will be designed to reduce the risk of those misstatements to an acceptable level.

[illegible]

VI. Document Your Conclusion With Respect to Internal Controls

	20__	20__	20__	20__
Prepared or updated by:				
In-Charge				
Reviewed by:				
Engagement Partner				

[The next page is 4325.]

AAM Section 4310

Control Environment Checklist—Small Business Computer Applications

.01 This questionnaire may be used to document your understanding of the way computers are used in the information and communication systems of a small business. This questionnaire should be used when the client uses either or both of the following to process significant accounting information.

- Microcomputers and off-the-shelf, unmodified software
- Outside computer service bureaus

.02

I. Microcomputer Hardware

Complete the form on the next page to describe the company's microcomputer hardware; for example:

Computer Model/Make:	Gateway Sb-4100-c
Processor	Intel Pentium 4 (2.4 GHz)
Memory and other information	512 MB memory; 80GB HD; 48x/24x/48x CD-RW/DVD combo
Software/Operating System:	Microsoft Office XP Small Business and Quicken
Peripherals:	Dedicated Printer

CONTROL ENVIRONMENT CHECKLIST
SMALL BUSINESS MICROCOMPUTER HARDWARE

<i>Person/Department</i>	<i>CPU Model/Make</i>	<i>Processor</i>	<i>RAM</i>	<i>Operating System</i>	<i>Hard-Disk Storage</i>	<i>Peripherals</i>

II. Microcomputer Accounting Software

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

Which of the following modules have been implemented?

<u>Module</u>	<u>Module Implemented</u>		
	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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.

<u>Name and Version</u>
<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:

<u>Name and Version</u>
Operating system
Network software
Network management software
<hr/>
<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>
Acquisition of Hardware					
1. The company has a coherent management plan for the purchase of and continued investment in computer hardware.	_____	_____	_____	_____	_____
2. The processing chips, RAM, and hard-disk storage are sufficient to meet the company's needs.	_____	_____	_____	_____	_____
3. The company's computer hardware is safely and properly installed.	_____	_____	_____	_____	_____
4. The company has standard, regular hardware maintenance procedures	_____	_____	_____	_____	_____
Acquisition of Software					
5. The company has a coherent management plan for the purchase and continued investment in computer software.	_____	_____	_____	_____	_____
6. The company researches software products to determine whether they meet the needs of the intended users.	_____	_____	_____	_____	_____
7. The company's application programs are compatible with each other.	_____	_____	_____	_____	_____
8. The company obtains recognized software from reputable sources and only accepts delivery if the software is in the manufacturer's sealed package.	_____	_____	_____	_____	_____
9. Company policy prohibits the use of unauthorized programs introduced by employees.	_____	_____	_____	_____	_____
10. Company policy prohibits the downloading of untested software from sources such as dial-up bulletin boards.	_____	_____	_____	_____	_____
11. The company uses virus protection software to screen for virus infections.	_____	_____	_____	_____	_____
Physical Security					
12. The company has established procedures for the periodic back-up of files.	_____	_____	_____	_____	_____

	<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, *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's report.

[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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested to determine the effectiveness of their design and operation.

.04 The processes, documents, and controls listed on this questionnaire are typical for small business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.05

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
I. Revenue and Accounts Receivable				
A. Initiating Sales Transactions				
1. Cash sales are controlled by cash registers or prenumbered cash receipts forms.	_____	_____	_____	_____
2. Someone other than the cashier has custody of the cash register tape compartment.	_____	_____	_____	_____
3. Someone other than the cashier takes periodic readings of the cash register and balances the cash on hand.	_____	_____	_____	_____
4. Credit limits are established by the owner or credit manager for customers who purchase on account.	_____	_____	_____	_____
5. Prenumbered sales orders are used and accounted for.	_____	_____	_____	_____
6. Prenumbered shipping documents are used to record shipments.	_____	_____	_____	_____
7. Shipping document information is verified prior to shipment.	_____	_____	_____	_____
8. All shipping documents are accounted for.	_____	_____	_____	_____
9. Prenumbered credit memos are used to document sales returns.	_____	_____	_____	_____
10. All credit memos are approved and accounted for.	_____	_____	_____	_____
11. Credit memos are matched with receiving reports for returned goods.	_____	_____	_____	_____
B. Processing Sales Transactions				
12. Prenumbered invoices are prepared promptly after goods are shipped.	_____	_____	_____	_____
13. Quantities on the invoices are compared to shipping documents.	_____	_____	_____	_____
14. The prices on the invoices are current.	_____	_____	_____	_____
15. Invoices are mailed to customers on a timely basis.	_____	_____	_____	_____
16. Invoices are posted to the general ledger on a timely basis.	_____	_____	_____	_____
17. Standard journal entries are used to record sales.	_____	_____	_____	_____
18. Invoices are posted to the sales and accounts receivable subsidiary ledgers or journals on a timely basis.	_____	_____	_____	_____
19. Credit memos are posted to the general ledger on a timely basis.	_____	_____	_____	_____
20. Credit memos are posted to the sales and accounts receivable subsidiary ledgers or journals on a timely basis.	_____	_____	_____	_____
21. Procedures exist for determining proper cut-off of sales at month end.	_____	_____	_____	_____
22. The sales and accounts receivable balances shown in the general ledger are reconciled to the sales and accounts receivable subsidiary ledgers on a regular basis.	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
C. Estimates and Disclosures for Sales Transactions				
23. The accounting system generates a monthly aging of accounts receivable.	_____	_____	_____	_____
24. The owner uses the accounts receivable aging to investigate, write-off or adjust delinquent accounts receivable.	_____	_____	_____	_____
25. The owner uses the accounts receivable aging and other information to estimate an allowance for doubtful accounts.	_____	_____	_____	_____
26. The person responsible for financial reporting identifies significant concentrations of credit risk.	_____	_____	_____	_____
II. Cash Receipts				
A. Initiating Cash Receipts Transactions				
1. The entity maintains records of payments on accounts by customer.	_____	_____	_____	_____
2. Someone other than the person responsible for maintaining accounts receivable opens the mail and lists the cash receipts.	_____	_____	_____	_____
3. Cash receipts are deposited intact.	_____	_____	_____	_____
4. Cash receipts are deposited in separate bank accounts when required.	_____	_____	_____	_____
B. Processing Cash Received on Account				
5. Cash receipts are posted to the general ledger on a timely basis.	_____	_____	_____	_____
6. Cash receipts are posted to the accounts receivable subsidiary ledger on a timely basis.	_____	_____	_____	_____
7. Standard journal entries are used to post cash receipts.	_____	_____	_____	_____
8. Timely bank reconciliations are prepared or reviewed by the owner or manager or someone independent of the cash receipts function.	_____	_____	_____	_____

End User Computing in the Revenue Cycle

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

.07 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of off-the-shelf computer software accounting applications such as the general ledger. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the revenue cycle to process significant accounting information outside of the general accounting software.

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

- Process significant accounting information outside of the off-the-shelf accounting software package. For example, a spreadsheet accumulates invoices for batch processing.

.09 In the space provided below, describe how end user computing is used in the revenue cycle. Describe—

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

Procedures and Controls Over End User Computing

.10 Answer the following questions relating to procedures and controls over end user computing related to the revenue cycle.

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

Information Processed by Outside Computer Service Organizations

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

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

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

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). This is especially the case when evidence of an entity's initiation, recording, or processing

of financial data exists only in electronic form. Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gather evidence to support an assessed level of control risk below the maximum for affected assertions. In situations where the auditor decides to rely on internal control and assess control risk below the maximum for certain assertions (including instances where the preponderance of electronic evidence necessitates it), tests of controls will need to be designed and then specific controls will need to be tested to determine the effectiveness of their design and operation.

.16 The processes, documents, and controls listed on this questionnaire are typical for small business entities but are by no means all-inclusive. The preponderance of "No" or "N/A" responses may indicate that the entity uses other processes, documents, or controls in their information and communication systems. You should consider supplementing this questionnaire with a memo or flowchart to document significant features of the client's system that are not covered by this questionnaire. See AAM section 4500 for example flowcharting techniques.

.17

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
I. Purchases and Accounts Payable				
A. Initiating Purchases and Receipt of Goods				
1. All purchases over a predetermined amount are approved by the owner.	_____	_____	_____	_____
2. Non-routine purchases (for example, services, fixed assets, or investments) are approved by the owner.	_____	_____	_____	_____
3. A purchase order system is used, prenumbered purchase orders are accounted for, and physical access to purchase orders is controlled.	_____	_____	_____	_____
4. Open purchase orders are periodically reviewed.	_____	_____	_____	_____
5. All goods are inspected and counted when received.	_____	_____	_____	_____
6. Prenumbered receiving reports, or a log, are used to record the receipt of goods.	_____	_____	_____	_____
7. The receiving reports or log indicate the date the items were received.	_____	_____	_____	_____
B. Processing Purchases				
8. Invoices from vendors are matched with applicable receiving reports.	_____	_____	_____	_____
9. Invoices are reviewed for proper quantity and prices, and mathematical accuracy.	_____	_____	_____	_____
10. Invoices from vendors are posted to the general ledger on a timely basis.	_____	_____	_____	_____
11. Invoices from vendors are posted to the accounts payable subsidiary ledger on a timely basis.	_____	_____	_____	_____
12. Standard journal entries are used to post accounts payable.	_____	_____	_____	_____
13. Accounts payable account per the general ledger is reconciled periodically to the accounts payable subsidiary ledger.	_____	_____	_____	_____
14. Statements from vendors are reconciled to the accounts payable subsidiary ledger.	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
C. Disclosures				
15. Management has the information to identify vulnerability due to concentrations of suppliers (SOP 94-6).	_____	_____	_____	_____
II. Cash Disbursements				
A. Initiating Cash Disbursements				
1. All disbursements except those from petty cash are made by check.	_____	_____	_____	_____
2. All checks are recorded.	_____	_____	_____	_____
3. Supporting documentation such as invoices and receiving reports are reviewed before the checks are signed.	_____	_____	_____	_____
4. Supporting documents are canceled to avoid duplicate payment.	_____	_____	_____	_____
B. Processing Cash Disbursements				
5. Cash disbursements are posted to the general ledger on a timely basis.	_____	_____	_____	_____
6. Cash disbursements are posted to the accounts payable subsidiary ledger on a timely basis.	_____	_____	_____	_____
7. Standard journal entries are used to post cash disbursements.	_____	_____	_____	_____
8. Timely bank reconciliations are prepared or reviewed by the owner or manager or someone independent of the cash receipts function.	_____	_____	_____	_____

End User Computing in the Purchasing Cycle

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

.19 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of off-the-shelf computer software accounting applications such as the general ledger. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the purchasing cycle to process significant accounting information outside of the general accounting software.

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

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

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

- The person or department who performs the computing.

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

Procedures and Controls Over End User Computing

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

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
Purchasing Cycle				
1. End user applications listed in paragraph .21 of this form have been adequately tested before use.	<hr/>	<hr/>	<hr/>	<hr/>
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 Control Environment Checklist—Small Business Computer Applications was used to document your understanding of the client’s use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the purchasing cycle.

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

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

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

Inventory

Inventory and Cost of Sales

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

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

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

Interpreting Results

.27 This checklist documents your understanding of how internal control over the inventory cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. 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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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>
I. Inventory and Cost of Sales				
A. Capturing Capitalizable Costs¹				
1. The entity uses a cost accounting system to accumulate capitalizable costs.	_____	_____	_____	_____
2. The cost accounting system distinguishes between costs that should be capitalized for GAAP purposes and those that should be capitalizable for tax purposes.	_____	_____	_____	_____
3. The cost accounting system interfaces with the general ledger.	_____	_____	_____	_____
4. Production cost budgets are periodically compared to actual costs, and significant differences are explained.	_____	_____	_____	_____
B. Inventory Records				
5. The entity maintains adequate inventory records of prices and amounts on hand.	_____	_____	_____	_____
6. Withdrawals from inventory are based on prenumbered finished inventory requisitions, shipping reports, or both.	_____	_____	_____	_____
7. Additions to and withdrawals from inventory are posted to the inventory records and the general ledger.	_____	_____	_____	_____
8. Standard journal entries are used to post inventory transactions to the inventory records and the general ledger.	_____	_____	_____	_____
9. Inventory records are periodically reconciled to the general ledger.	_____	_____	_____	_____
10. Inventory records are reconciled to a physical inventory count.	_____	_____	_____	_____
C. Physical Inventory Counts				
11. Inventory is counted at least once a year.	_____	_____	_____	_____
12. Physical inventory counters are given adequate instructions.	_____	_____	_____	_____
13. Inventory count procedures are sufficient to provide an accurate count, including steps to ensure—				
• Proper cut-off.	_____	_____	_____	_____
• Identification of obsolete items.	_____	_____	_____	_____
• All items are counted once and only once.	_____	_____	_____	_____
• Tag control.	_____	_____	_____	_____
D. Estimates and Disclosures				
14. Management is able to identify excess, slow-moving, or obsolete inventory.	_____	_____	_____	_____

¹ You should also consider completing the Financial Reporting Information Systems and Controls Checklist for the purchasing cycle to document your understanding of how the purchase of inventory is initiated.

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>
Inventory Cycle				
1. End user applications listed in paragraph .33 of this form have been adequately tested before use.	_____	_____	_____	_____
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	_____	_____	_____	_____
3. Access controls limit access to the end user application.	_____	_____	_____	_____
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	_____	_____	_____	_____
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	_____	_____	_____	_____

Information Processed by Outside Computer Service Organizations

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

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

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

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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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>
I. Investments				
A. Authorization and Initiation				
1. Investment transactions are authorized by the owner.	_____	_____	_____	_____
2. The owner assesses and understands the risks associated with the entity's investments.	_____	_____	_____	_____
3. Investments are registered in the name of the company.	_____	_____	_____	_____
4. At acquisition, investments are classified as trading, available-for-sale, or held-to-maturity.	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
B. Processing				
5. Investment transactions are posted to the general ledger on a timely basis.	_____	_____	_____	_____
6. Account statements received from brokers are reviewed for accuracy.	_____	_____	_____	_____
7. Discounts and premiums are amortized regularly using the interest method.	_____	_____	_____	_____
8. Procedures exist to determine the fair value of trading and available-for-sale securities.	_____	_____	_____	_____
9. The general ledger is periodically reconciled to account statements from brokers or physical counts of securities on hand.	_____	_____	_____	_____
C. Disclosures				
10. Management identifies all the information about its securities that is necessary for proper disclosure.	_____	_____	_____	_____
II. Debt				
A. Authorization and Initiation				
1. Financing transactions are authorized by the owner.	_____	_____	_____	_____
2. The owner assesses and understands all terms, covenants, restrictions of debt transactions.	_____	_____	_____	_____
B. Processing and Documentation				
3. Debt transactions are posted to the general ledger on a timely basis.	_____	_____	_____	_____
4. Any premiums or discount are amortized using the interest method.	_____	_____	_____	_____
5. The company maintains up-to-date files of all notes payable.	_____	_____	_____	_____
C. Disclosure				
6. Procedures exist to determine the fair value of notes payable for proper disclosure.	_____	_____	_____	_____
7. Management reviews their compliance with debt covenants on a timely basis.	_____	_____	_____	_____

End User Computing in the Financing Cycle

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

.43 The Control Environment Checklist—Small Business Computer Applications was used to document your understanding of off-the-shelf computer software accounting applications such as the general ledger. In this section of the Financial Reporting Information Systems and Controls Checklist, you may document your understanding of how end user computing is used in the financing cycle to process significant accounting information outside of the general accounting software.

Information Processed by Outside Computer Service Organizations

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

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

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

Property, Plant, and Equipment

Fixed Assets and Depreciation

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

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

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

Interpreting Results

.51 This checklist documents your understanding of how internal control over property, plant, and equipment is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. 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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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>
I. Fixed Assets and Depreciation				
A. Authorization and Initiation				
1. Fixed asset acquisitions and retirements are authorized by the owner.	_____	_____	_____	_____
B. Processing and Documentation				
2. The company maintains detailed records of fixed assets and the related accumulated depreciation.	_____	_____	_____	_____
3. The general ledger and detailed fixed asset records are updated for fixed assets transactions on a timely basis.	_____	_____	_____	_____
4. A process exists for the timely calculation of depreciation expense for both book and tax purposes.	_____	_____	_____	_____
5. The general ledger and detailed fixed asset records are updated for depreciation expense on a timely basis.	_____	_____	_____	_____
6. The general ledger is periodically reconciled to the detailed fixed asset records.	_____	_____	_____	_____
C. Disclosure and Estimation				
7. Management identifies events or changes in circumstances that may indicate fixed assets have been impaired (SFAS 144).	_____	_____	_____	_____
8. Management assesses and understands the risk of specialized equipment becoming subject to technological obsolescence (SOP 94-6).	_____	_____	_____	_____

[illegible]

.58 Answer the following questions relating to procedures and controls over end user computing related to the property, plant, and equipment cycle.

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
Property, Plant, and Equipment Cycle				
1. End user applications listed in paragraph .57 of this form have been adequately tested before use.	_____	_____	_____	_____
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	_____	_____	_____	_____
3. Access controls limit access to the end user application.	_____	_____	_____	_____
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	_____	_____	_____	_____
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	_____	_____	_____	_____

Information Processed by Outside Computer Service Organizations

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

.60 In the space below, describe the property, plant, and equipment cycle information processed by the outside computer service bureau. Discuss—

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

Payroll Cycle

Payroll Expense

.61 This checklist may be used on any small business audit engagement where the payroll cycle is significant.

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

- How the time worked by employees is captured by the financial reporting information system.

- How salaries and hourly rates are established.
- How payroll and the related withholdings are calculated.
- The accounting records and supporting documents involved in the processing and reporting of payroll.

Interpreting Results

.63 This checklist documents your understanding of how internal control over the payroll cycle is designed and whether it has been placed in operation. It should help you in planning a primarily substantive approach. In entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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>
I. Payroll				
A. Initiating Payroll Transactions				
1. Wages and salaries are approved by the owner.	_____	_____	_____	_____
2. Proper authorization is obtained for all payroll deductions.	_____	_____	_____	_____
3. Access to personnel files is limited to the owner or someone who is independent of the payroll or cash functions.	_____	_____	_____	_____
4. Adequate time records are maintained for employees paid by the hour.	_____	_____	_____	_____
5. Time records for hourly employees are approved by a supervisor.	_____	_____	_____	_____
B. Processing Payroll				
6. Payroll is calculated using authorized pay rates, payroll deductions, and time records.	_____	_____	_____	_____
7. Payroll registers are reviewed for accuracy.	_____	_____	_____	_____
8. Standard journal entries are used to post payroll transactions to the general ledger.	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
Payroll Cycle				
1. End user applications listed in paragraph .69 of this form have been adequately tested before use.	_____	_____	_____	_____
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	_____	_____	_____	_____
3. Access controls limit access to the end user application.	_____	_____	_____	_____
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	_____	_____	_____	_____
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	_____	_____	_____	_____

Information Processed by Outside Computer Service Organizations

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

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

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

[The next page is 4401.]

AAM Section 4400

Illustrative Internal Control Forms— Medium to Large Business

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

Instructions

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

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

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

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

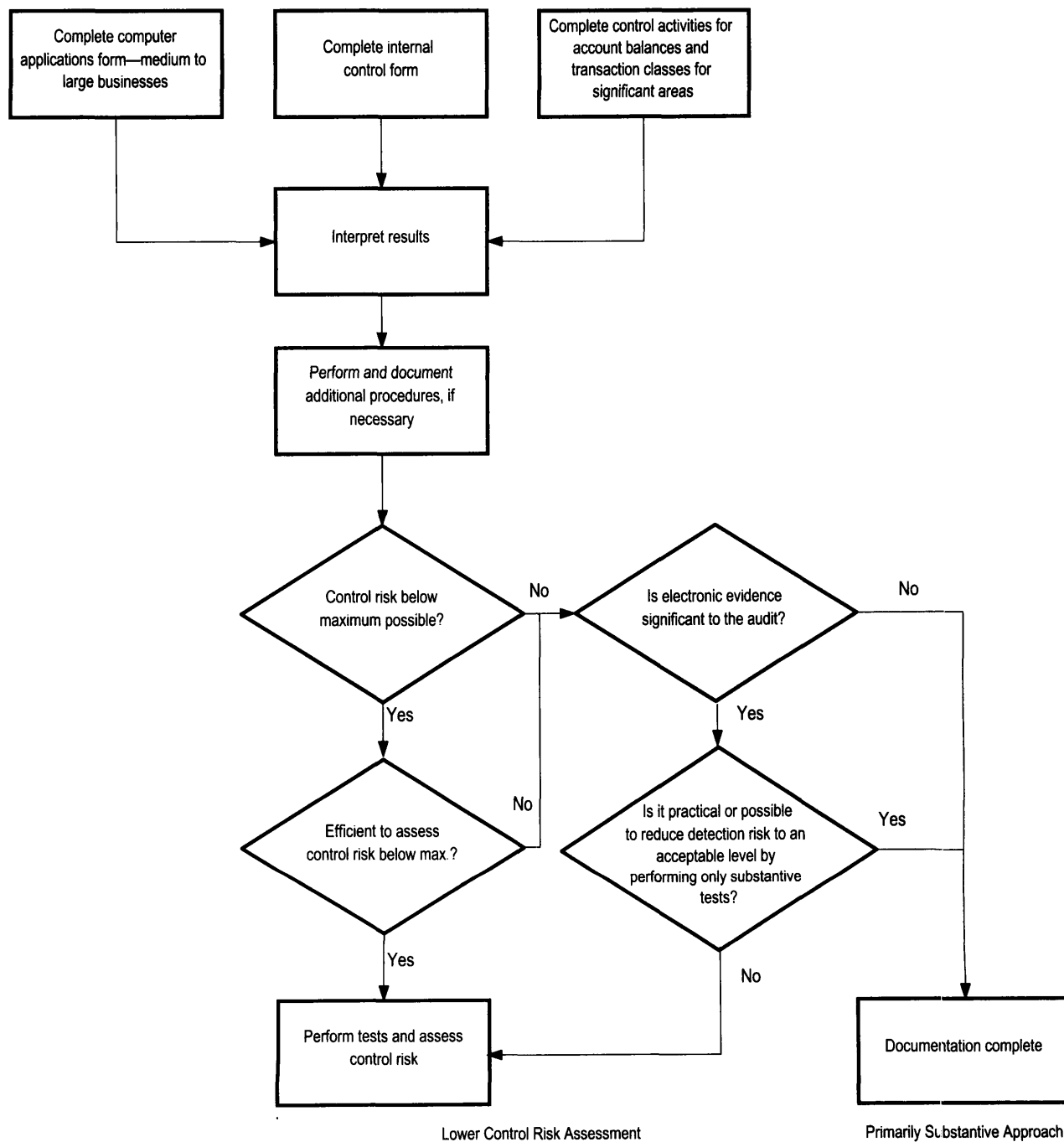
.06 If you plan a lower control risk assessment for certain assertions you are required to—

- 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 significant 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 especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form.) 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>
A. Control Environment Factors					
<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.	_____	_____	_____	_____	_____
<i>Board of Directors and Audit Committee</i>					
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.	_____	_____	_____	_____	_____
• Uncorrected audit adjustments.	_____	_____	_____	_____	_____
• 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.	_____	_____	_____	_____	_____
<i>Management's Philosophy and Operating Style</i>					
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.	_____	_____	_____	_____	_____
<i>Human Resource Policies and Practices</i>					
37. The entity generally hires the most qualified people for the job.	_____	_____	_____	_____	_____
38. Hiring and recruiting practices emphasize educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior.	_____	_____	_____	_____	_____
39. Recruiting practices include formal, in-depth employment interviews.	_____	_____	_____	_____	_____
40. Prospective employees are told of the entity's history, culture and operating style.	_____	_____	_____	_____	_____
41. The entity provides training opportunities, and employees are well-trained.	_____	_____	_____	_____	_____
42. Promotions and rotation of personnel are based on periodic performance appraisals.	_____	_____	_____	_____	_____
43. Methods of compensation, including bonuses, are designed to motivate personnel and reinforce outstanding performance.	_____	_____	_____	_____	_____
44. Management does not hesitate to take disciplinary action when violations of expected behavior occur.	_____	_____	_____	_____	_____
B. Other Internal Control Components With a Pervasive Effect on the Organization					
<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.	_____	_____	_____	_____	_____

	<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.	_____	_____	_____	_____	_____
General Control Activities					
10. The entity prepares operating budgets and cash flow projections.	_____	_____	_____	_____	_____
11. Operating budgets and projections lend themselves to effective comparison with actual results.	_____	_____	_____	_____	_____
12. Significant variances between budgeted or projected amounts and actual results are reviewed and explained.	_____	_____	_____	_____	_____
13. The company has adequate safekeeping facilities for custody of the accounting records such as 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.	_____	_____	_____	_____	_____
Information and Communication					
18. Management receives the information they need to carry out their responsibilities.	_____	_____	_____	_____	_____
19. Information is provided at the right level of detail for different levels of management.	_____	_____	_____	_____	_____
20. Information is available on a timely basis.	_____	_____	_____	_____	_____
21. Information with accounting significance (for example, slow-paying customers) is transmitted across functional lines in a timely manner.	_____	_____	_____	_____	_____
Monitoring					
22. Customer complaints about billings are investigated for their underlying causes.	_____	_____	_____	_____	_____
23. Communications from bankers, regulators, or other outside parties are monitored for items of accounting significance.	_____	_____	_____	_____	_____
24. Management responds appropriately to auditor recommendations on ways to strengthen internal controls.	_____	_____	_____	_____	_____
25. Employees are required to "sign off" to evidence the performance of critical control functions.	_____	_____	_____	_____	_____
26. The internal auditors are independent of the activities they audit.	_____	_____	_____	_____	_____
27. Internal auditors have adequate training and experience.	_____	_____	_____	_____	_____
28. Internal auditors document the planning and execution of their work by such means as audit programs and working papers.	_____	_____	_____	_____	_____
29. Internal audit reports are submitted to the board of directors or audit committee.	_____	_____	_____	_____	_____

II. Determine Other Areas For Evaluation

The completion of section I of this form is the first of several forms that may be used to document your understanding of internal controls sufficiently to plan a primarily substantive audit. It is important to remember that in entities where significant information is transmitted, processed, maintained, or accessed electronically, just gaining an understanding of the controls surrounding the electronic environment may not be enough. Since the competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness, an auditor may have to test the internal control surrounding that evidence to gain competent evidential matter—even in a primarily substantive approach. In the space provided below, determine which of the following areas apply. A "Yes" answer generally indicates you should complete the related form.

No Yes W/P Ref.

Significant Account Balances and Transaction Cycles

1. The following account balances or transaction cycles are significant to the company's financial statements.

- a. Revenue Cycle, including sales, accounts receivable, or cash receipts. (Normally considered significant for most businesses.)

If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—

- b. Purchasing Cycle, including purchasing, accounts payable, or cash disbursements. (Normally considered significant for most businesses.)

If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—

- c. Inventory, including inventory and cost of sales.

If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—

- d. Financing, including investments and debt.

If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—

- e. Property, Plant, and Equipment, including fixed assets and depreciation.

If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—

- f. Payroll.

If "yes," the related Financial Reporting Information Systems and Controls Checklist can be found at—

III. Assess Lack of Segregation of Duties

In the space provided below, assess risk due to a lack of segregation of duties for the company, based on the completion of sections I and II of this form. Your comments should address—

- The person with incompatible responsibilities and the nature of those responsibilities.

- Any mitigating factors or controls, such as direct management oversight.
- The risk that material misstatements might occur as a result of a lack of segregation of duties, and the type of those misstatements.
- How substantive procedures will be designed to limit the risk of those misstatements to an acceptable level.

IV. Assess the Risk of Management Override

Even in effectively controlled entities—those with generally high levels of integrity and control consciousness—a manager might be able to override controls. The term “management override” means—

Overruling prescribed policies or procedures for *illegitimate* purposes with the intent of personal gain or enhanced presentation of an entity’s financial condition or compliance status.

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

An active, involved board of directors can significantly reduce the risk of management override.

Management override is different from management intervention, which is the overrule of prescribed policies or procedures for legitimate purposes. For example, management intervention is usually necessary to deal with non-recurring and non-standard transactions or events that otherwise might be handled by the system.

In the space below, assess the risk of management *override* for this company. You should consider the risk that management override possibilities exist, the risk that management will take advantage of those possibilities, and any evidence that management has engaged in override practices. If the risk of management override is greater than low, indicate how planned audit procedures will reduce this risk to an acceptable level.

VI. Document Your Conclusion With Respect to Internal Controls

	20__	20__	20__	20__
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>
Acquisition of Hardware					
1. The company has a coherent management plan for the purchase and continued investment in computer hardware.	_____	_____	_____	_____	_____
2. The computer hardware is sufficient to meet the company’s needs.	_____	_____	_____	_____	_____

	<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.	_____	_____	_____	_____	_____
Acquisition of Software					
5. The company has a coherent management plan for the purchase of and continued investment in computer software.	_____	_____	_____	_____	_____
6. The company researches software products to determine whether they meet the needs of the intended users.	_____	_____	_____	_____	_____
7. The company's application programs are compatible with each other.	_____	_____	_____	_____	_____
8. The company obtains recognized software from reputable sources.	_____	_____	_____	_____	_____
9. Company policy prohibits the use of unauthorized programs introduced by employees.	_____	_____	_____	_____	_____
10. Company policy prohibits the downloading of untested software from sources such as dial-up bulletin boards.	_____	_____	_____	_____	_____
11. The company uses virus protection software to screen for virus infections.	_____	_____	_____	_____	_____
Program Development					
12. Users are involved in the design and approval of systems.	_____	_____	_____	_____	_____
13. Users review the completion of various phases of the application.	_____	_____	_____	_____	_____
14. New programs are thoroughly tested.	_____	_____	_____	_____	_____
15. Users are involved in the review of tests of the program.	_____	_____	_____	_____	_____
16. Adequate procedures exist to transfer programs from development to production libraries.	_____	_____	_____	_____	_____
Program Changes					
17. Users are involved in the design and approval of program changes.	_____	_____	_____	_____	_____

	<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, *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.

[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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
I. Revenue and Accounts Receivable				
A. Initiating Sales Transactions				
1. Credit limits are clearly defined.	_____	_____	_____	_____
2. Credit limits are clearly communicated.	_____	_____	_____	_____
3. The credit of prospective customers is investigated before it is extended to them.	_____	_____	_____	_____
4. Credit limits are periodically reviewed.	_____	_____	_____	_____
5. The people who perform the credit function are independent of—				
• Sales.	_____	_____	_____	_____
• Billing.	_____	_____	_____	_____
• Collection.	_____	_____	_____	_____
• Accounting.	_____	_____	_____	_____
6. Credit limits and changes in credit limits are communicated to persons responsible for approving sales orders on a timely basis.	_____	_____	_____	_____
7. The company has clearly defined policies and procedures for acceptance and approval of sales orders.	_____	_____	_____	_____
8. Prenumbered sales orders are used and accounted for.	_____	_____	_____	_____
9. Prenumbered shipping documents are used to record shipments.	_____	_____	_____	_____
10. Shipping document information is verified prior to shipment.	_____	_____	_____	_____
11. The people who perform the shipping function are independent of—				
• Sales.	_____	_____	_____	_____
• Billing.	_____	_____	_____	_____
• Collection.	_____	_____	_____	_____
• Accounting.	_____	_____	_____	_____
12. All shipping documents are accounted for.	_____	_____	_____	_____
13. Prenumbered credit memos are used to document sales returns.	_____	_____	_____	_____
14. All credit memos are approved and accounted for.	_____	_____	_____	_____
15. Credit memos are matched with receiving reports for returned goods.	_____	_____	_____	_____
16. Cash sales are controlled by cash registers or prenumbered cash receipts forms.	_____	_____	_____	_____
17. Someone other than the cashier has custody to the cash register tape compartment.	_____	_____	_____	_____

	<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. Processing Sales Transactions				
19. Information necessary to prepare invoices (e.g., prices, discount policies) is clearly communicated to billing personnel on a timely basis.	_____	_____	_____	_____
20. Prenumbered invoices are prepared promptly after goods are shipped.	_____	_____	_____	_____
21. Quantities on the invoices are compared to shipping documents.	_____	_____	_____	_____
22. The prices on the invoices are current.	_____	_____	_____	_____
23. The people who perform the billing function are independent of—				
• Sales.	_____	_____	_____	_____
• Credit.	_____	_____	_____	_____
• Collection.	_____	_____	_____	_____
24. Invoices are mailed to customers on a timely basis.	_____	_____	_____	_____
25. Invoices are posted to the general ledger on a timely basis.	_____	_____	_____	_____
26. Standard journal entries are used to record sales.	_____	_____	_____	_____
27. Invoices are posted to the sales and accounts receivable subsidiary ledgers or journals on a timely basis.	_____	_____	_____	_____
28. Credit memos are posted to the general ledger on a timely basis.	_____	_____	_____	_____
29. Credit memos are posted to the sales and accounts receivable subsidiary ledgers or journals on a timely basis.	_____	_____	_____	_____
30. Procedures exist for determining proper cut-off of sales at month-end.	_____	_____	_____	_____
31. The sales and accounts receivable balances shown in the general ledger are reconciled to the sales and accounts receivable subsidiary ledgers on a regular basis.	_____	_____	_____	_____
C. Estimates and Disclosures for Sales Transactions				
32. The accounting system generates a monthly aging of accounts receivable.	_____	_____	_____	_____
33. The people who prepare the aging are independent of—				
• Billing.	_____	_____	_____	_____
• Collection.	_____	_____	_____	_____
34. Management uses the accounts receivable aging to investigate, write off, or adjust delinquent accounts receivable.	_____	_____	_____	_____

	<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 IT 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 IT 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.

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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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>
I. Purchases and Accounts Payable				
A. Initiating Purchases and Receipt of Goods				
1. All purchases over a predetermined amount are approved by management.	_____	_____	_____	_____
2. Non-routine purchases (for example, services, fixed assets, or investments) are approved by management.	_____	_____	_____	_____
3. A purchase order system is used, prenumbered purchase orders are accounted for, and physical access to purchase orders is controlled.	_____	_____	_____	_____
4. Open purchase orders are periodically reviewed.	_____	_____	_____	_____
5. The purchasing function is independent of—				
• Receiving	_____	_____	_____	_____
• Invoice processing	_____	_____	_____	_____
• Cash disbursements	_____	_____	_____	_____
6. All goods are inspected and counted when received.	_____	_____	_____	_____
7. Prenumbered receiving reports, or a log, are used to record the receipt of goods.	_____	_____	_____	_____
8. The receiving reports or log indicate the date the items were received.	_____	_____	_____	_____
9. The receiving function is independent of—				
• Purchasing	_____	_____	_____	_____
• Invoice processing	_____	_____	_____	_____
• Cash disbursements	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
B. Processing Purchases				
10. Invoices from vendors are matched with applicable receiving reports.	_____	_____	_____	_____
11. Invoices are reviewed for proper quantity and prices, and mathematical accuracy.	_____	_____	_____	_____
12. Invoices from vendors are posted to the general ledger on a timely basis.	_____	_____	_____	_____
13. Invoices from vendors are posted to the accounts payable subsidiary ledger on a timely basis.	_____	_____	_____	_____
14. The invoice processing function is independent of—				
• Purchasing	_____	_____	_____	_____
• Receiving	_____	_____	_____	_____
• Cash disbursements	_____	_____	_____	_____
15. Standard journal entries are used to post accounts payable.	_____	_____	_____	_____
16. Accounts payable account per the general ledger is reconciled periodically to the accounts payable subsidiary ledger.	_____	_____	_____	_____
17. Statements from vendors are reconciled to the accounts payable subsidiary ledger.	_____	_____	_____	_____
C. Disclosures				
18. Management has the information to identify vulnerability due to concentrations of suppliers (SOP 94-6).	_____	_____	_____	_____
II. Cash Disbursements				
A. Initiating Cash Disbursements				
1. All disbursements except those from petty cash are made by check.	_____	_____	_____	_____
2. All checks are recorded.	_____	_____	_____	_____
3. Supporting documentation such as invoices and receiving reports are reviewed before the checks are signed.	_____	_____	_____	_____
4. Supporting documents are canceled to avoid duplicate payment.	_____	_____	_____	_____
B. Processing Cash Disbursements				
5. Cash disbursements are posted to the general ledger on a timely basis.	_____	_____	_____	_____
6. Cash disbursements are posted to the accounts payable subsidiary ledger on a timely basis.	_____	_____	_____	_____
7. Standard journal entries are used to post cash disbursements.	_____	_____	_____	_____
8. Timely bank reconciliations are prepared or reviewed by the owner or manager or someone independent of the cash receipts function.	_____	_____	_____	_____

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

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

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

Procedures and Controls Over End User Computing

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

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

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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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>
I. Inventory and Cost of Sales				
A. Capturing Capitalizable Costs¹				
1. Management prepares production goals and schedules based on sales forecasts.	_____	_____	_____	_____
2. The company budgets its planned inventory levels.	_____	_____	_____	_____
3. All releases from storage of raw materials, supplies, and purchased parts inventory are based on approved requisition documents.	_____	_____	_____	_____
4. Labor costs are reported promptly and in sufficient detail to allow for the proper allocation to inventory.	_____	_____	_____	_____
5. The entity uses a cost accounting system to accumulate capitalizable costs.	_____	_____	_____	_____

¹ You should also consider completing the Financial Reporting Information Systems and Controls Checklist for the purchasing cycle to document your understanding of how the purchase of inventory is initiated.

	<i>Personnel</i>	<i>N/A</i>	<i>No</i>	<i>Yes</i>
6. The cost accounting system distinguishes between costs that should be capitalized for GAAP purposes and those that should be capitalizable for tax purposes.	_____	_____	_____	_____
7. For standard cost systems:				
a. Standard rates and volume are periodically compared to actual and revised accordingly.	_____	_____	_____	_____
b. Significant variances are investigated.	_____	_____	_____	_____
8. The cost accounting system interfaces with the general ledger.	_____	_____	_____	_____
9. Transfers of completed units from production to custody of finished goods inventory are based on approved completion reports that authorize the transfer.	_____	_____	_____	_____
10. The people responsible for maintaining detailed inventory records are independent from the physical custody and handling of inventories.	_____	_____	_____	_____
11. Production cost budgets are periodically compared to actual costs, and significant differences are explained.	_____	_____	_____	_____
B. Inventory Records				
12. The entity maintains adequate inventory records of prices and amounts on hand.	_____	_____	_____	_____
13. Withdrawals from inventory are based on prenumbered finished inventory requisitions, shipping reports, or both.	_____	_____	_____	_____
14. Additions to and withdrawals from inventory are posted to the inventory records and the general ledger.	_____	_____	_____	_____
15. Standard journal entries are used to post inventory transactions to the inventory records and the general ledger.	_____	_____	_____	_____
16. Inventory records are periodically reconciled to the general ledger.	_____	_____	_____	_____
17. Inventory records are reconciled to a physical inventory count.	_____	_____	_____	_____
C. Physical Inventory Counts				
18. Inventory is counted at least once a year.	_____	_____	_____	_____
19. Physical inventory counters are given adequate instructions.	_____	_____	_____	_____
20. Inventory count procedures are sufficient to provide an accurate count, including steps to ensure—				
• Proper cut-off.	_____	_____	_____	_____
• Identification of obsolete items.	_____	_____	_____	_____
• All items are counted once and only once.	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
D. Estimates and Disclosures				
21. Management is able to identify excess, slow-moving, or obsolete inventory.	_____	_____	_____	_____
22. Excess, slow-moving, or obsolete inventory is periodically written off.	_____	_____	_____	_____
23. Management can identify inventory subject to rapid technological obsolescence that may need to be disclosed under SOP 94-6.	_____	_____	_____	_____

End User Computing in the Inventory Cycle

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

.31 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of computer applications operated by the company's IT 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 IT 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 IT-operated accounting application. For example, a spreadsheet calculates overhead cost allocations.
- Make significant accounting decisions. A spreadsheet application tracks slow-moving items for possible write-off.
- Accumulate footnote information.

.33 In the space provided below, describe how end user computing is used in the inventory cycle. Describe—

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

Procedures and Controls Over End User Computing

.34 Answer the following questions relating to procedures and controls over end user computing related to the inventory cycle.

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

Information Processed by Outside Computer Service Organizations

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

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

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

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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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

I. Investments

A. Authorization and Initiation

1. Investment transactions are authorized by management.

Personnel N/A No Yes

	<i>Personnel</i>	<i>N/A</i>	<i>No</i>	<i>Yes</i>
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. The entity accumulates the information necessary to make disclosures about investments and derivatives.	_____	_____	_____	_____
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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>
Financing Cycle				
1. End user applications listed in paragraph .45 of this form have been adequately tested before use.	_____	_____	_____	_____
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	_____	_____	_____	_____
3. Access controls limit access to the end user application.	_____	_____	_____	_____
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	_____	_____	_____	_____
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	_____	_____	_____	_____

Information Processed by Outside Computer Service Organizations

.47 The Computer Applications Checklist—Medium to Large Business was used to document your understanding of the client’s use of an outside computer service organization to process entity-wide accounting information such as the general ledger. In this section you will document your understanding of how the entity uses an outside computer service organization to process information relating specifically to the financing cycle.

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

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

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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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>
I. Fixed Assets and Depreciation				
A. Authorization and Initiation				
1. Fixed asset acquisitions and retirements are authorized by management.	_____	_____	_____	_____
B. Processing and Documentation				
2. The company maintains detailed records of fixed assets and the related accumulated depreciation.	_____	_____	_____	_____

	<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.	_____	_____	_____	_____

C. Disclosure and Estimation

8. Management identifies events or changes in circumstances that may indicate fixed assets have been impaired (SFAS 144).	_____	_____	_____	_____
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 IT 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 IT 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 IT-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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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>
I. Payroll				
A. Initiating Payroll Transactions				
1. Wages and salaries are approved by management.	_____	_____	_____	_____
2. Salaries of senior management are based on written authorization of the board of directors.	_____	_____	_____	_____
3. Bonuses are authorized by the board of directors.	_____	_____	_____	_____
4. Employee benefits and perks are granted in accordance with management's authorization.	_____	_____	_____	_____
5. Senior management benefits and perks are authorized by the board of directors.	_____	_____	_____	_____
6. Proper authorization is obtained for all payroll deductions.	_____	_____	_____	_____
7. Access to personnel files is limited to those who are independent of the payroll or cash functions.	_____	_____	_____	_____
8. Wage and salary rates and payroll deductions are reported promptly to employees who perform the payroll processing function.	_____	_____	_____	_____
9. Changes in wage and salary rates and payroll deductions are reported promptly to employees who perform the payroll processing function.	_____	_____	_____	_____
10. Adequate time records are maintained for employees paid by the hour.	_____	_____	_____	_____
11. Time records for hourly employees are approved by a supervisor.	_____	_____	_____	_____
B. Processing Payroll				
12. Payroll is calculated using authorized pay rates, payroll deductions, and time records.	_____	_____	_____	_____
13. Payroll registers are reviewed for accuracy.	_____	_____	_____	_____
14. Standard journal entries are used to post payroll transactions to the general ledger.	_____	_____	_____	_____
15. Payroll cost distributions are reconciled to gross pay.	_____	_____	_____	_____
16. Payroll information such as hours worked is periodically compared to production records.	_____	_____	_____	_____
17. Net pay is distributed by persons who are independent of personnel, payroll preparation, time-keeping, and check preparation functions.	_____	_____	_____	_____
18. The responsibility for custody and follow-up of unclaimed wages is assigned to someone who is independent of personnel, payroll processing, and cash disbursement functions.	_____	_____	_____	_____
19. Procedures are in place to estimate the fair value of stock-based compensation plans.	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
Payroll Cycle				
1. End user applications listed in paragraph .69 of this form have been adequately tested before use.	_____	_____	_____	_____
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	_____	_____	_____	_____
3. Access controls limit access to the end user application.	_____	_____	_____	_____
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	_____	_____	_____	_____
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	_____	_____	_____	_____

Information Processed by Outside Computer Service Organizations

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

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

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

[The next page is 4501.]

AAM Section 4500

Flowcharting

Introduction

.01 AAM sections 4300 and 4400 provided a series of forms you may use to document your understanding of a client's internal control system. Included in those forms were several Financial Reporting Information Systems and Controls Checklists to document your understanding of the accounting system and controls for significant account balances. As an alternative or supplement to those checklists, you may wish to include a flowchart. In some instances, a flowchart may be easier to read and analyze than a checklist or memo.

.02 In general you will want to identify the following for your client's significant accounts and transactions:

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

.03 An entity's financial reporting information system may create many documents, files, and reports that are useful for managing the organization. As an auditor you need to understand and document only those aspects that are relevant to the audit of the financial statements. Documents, files, and reports that are not relevant to your audit need not be presented on a flowchart. For example, the same system that produces sales invoices and a sales journal may also produce a report of sales by salesperson. An understanding of this report may not be necessary to plan the audit.

.04 It is *not* necessary for you to understand how every copy of accounting documents may be used by the client. When the client prepares numerous copies of a document, you are concerned only with those relevant to the flow of transactions from initiation to inclusion in the financial statements.

Example: Jones Grocery

.05 *Jones Grocery is an eight-store chain of independent grocery stores in Anytown. The accounts payable cycle is described in the following paragraphs.*

.06 *When goods are received at each store, the store manager or another responsible employee counts and inspects the goods and checks them against the packing slip. A copy is retained by the store manager and the original is forwarded to the main store for processing.*

.07 *All vendor invoices are mailed directly to the main store, to the attention of Mrs. Jones. Her assistant matches the invoices to the packing slips received from individual stores. He investigates any discrepancies between quantities billed and quantities received, per the packing slips. He also follows up on any invoices received for which the store manager has not forwarded the packing slip.*

.08 The invoices are coded and then entered into the accounts payable module of the company's accounting software system. The invoices with attached packing slips are stored in a temporary file until they are paid.

.09 The computer system automatically updates the general ledger. It also produces two reports: an accounts payable subledger and an accounts payable aging. When statements are received from the vendors, Mrs. Jones checks them against the accounts payable subledger and investigates any differences. Periodically, she reconciles the accounts payable subledger to the general ledger. The accounts payable aging is checked to make sure totals agree to the accounts payable subledger.

.10 Mr. Jones writes the checks. There is a module in the software that links the accounts payable module to the cash disbursements module and automatically prints checks, but this was too confusing to install. The volume of checks is not that great, so the company prepares them manually.

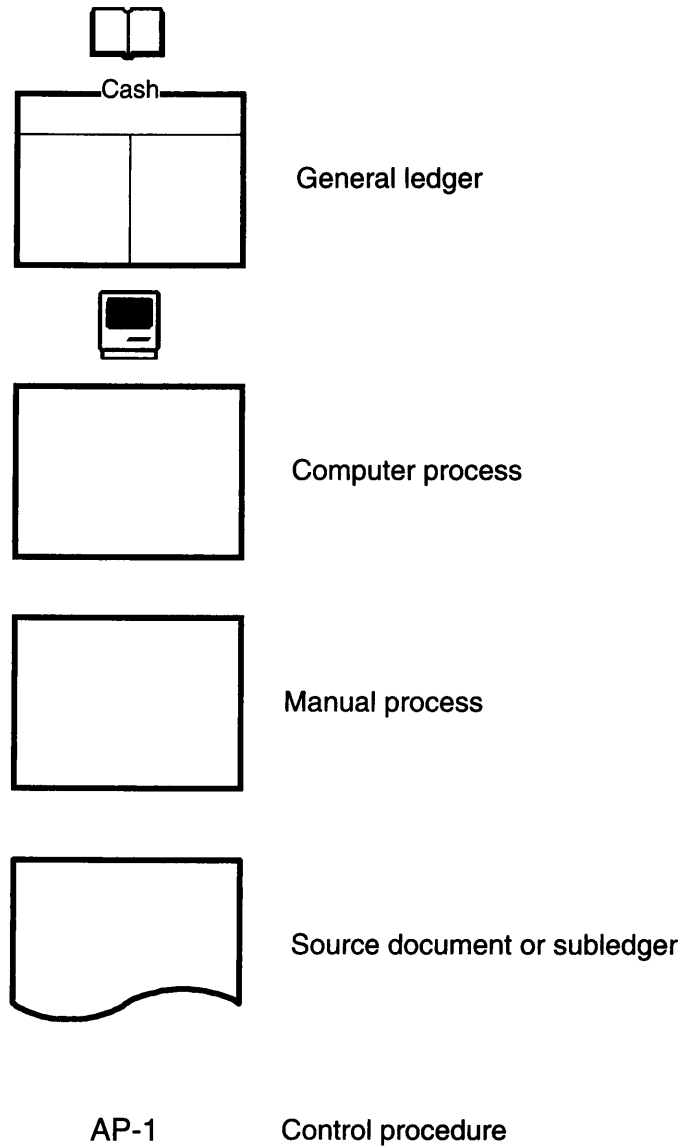
.11 Vendors are paid by invoice, not by statement. Payments are made monthly. Mr. Jones uses the accounts payable aging to determine which invoices should be paid. He marks these on the report and gives it to his secretary to prepare the checks. The matched vendor invoices and receiving reports that have been stored in temporary files are attached to the typed check for Mr. Jones' signature. Two check copies are retained: one is attached and filed with the invoice and a second is filed numerically.

.12 Once the checks are signed, they are coded and entered into the cash disbursements module of the accounting software package. The software updates the general ledger, the accounts payable subledger and aging, and produces a cash disbursements report. It also produces a cash management report that may be used to estimate the future cash needs of the business.

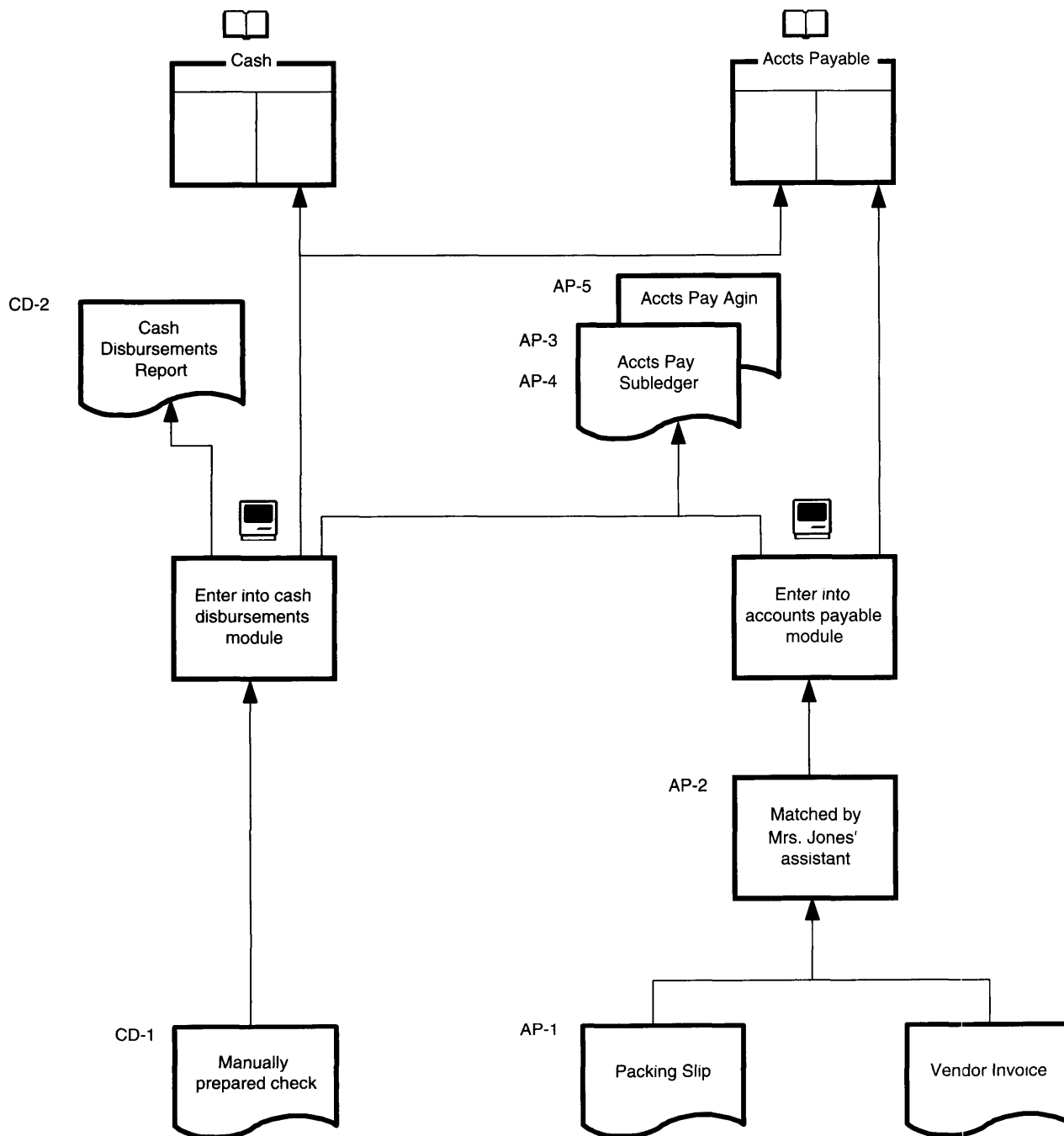
.13 Monthly, the cash disbursements report is used to reconcile the cash accounts to the bank statements.

The Flowchart

.14 The flowchart on the following page illustrates how an auditor might flowchart the accounts payable system described in AAM section 4500.05 through .13. The following symbols have been used.



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.

[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. This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. The competence of electronic evidence usually depends on the effectiveness of internal control over its validity and completeness. (The term electronic evidence means information transmitted, processed, maintained, or accessed by electronic means and used by an auditor to evaluate financial statement assertions.) Without testing the internal control surrounding the electronic evidence, a lack of credibility may not be recognized by the auditor. Therefore, when using electronic evidence, auditors need to question the appropriateness of the approach of performing only substantive testing if ineffective controls exist, or if assessed control risk is at the maximum level. Given the nature of electronic evidence, it usually will be necessary to test the surrounding internal control (to gather evidence to support an assessed level of control risk below the maximum) if that electronic evidence is significant in supporting an auditor's conclusion regarding certain financial statement assertions. If the auditor concludes control risk must be assessed at the maximum in such circumstances, or the evidence gathered through tests of controls and substantive tests is insufficient, the auditor should qualify or disclaim an opinion because of the scope limitation.

Practice Tip

Read the AICPA's Auditing Procedure Study entitled *The Information Technology Age: Evidential Matter in the Electronic Environment* for helpful and valuable guidance about the implications of electronic evidence on an audit. Call the AICPA at (888) 777-7077 and ask for product number 021068.

You may choose to assess control risk at the maximum either for audit efficiency purposes or because of ineffective controls. If you choose a primarily substantive audit because the controls are ineffective, you may have additional concerns about the auditability of the entity and other questions. Assuming you are able to overcome auditability concerns, you may respond by heightening the degree of professional skepticism, assigning more experienced staff, and changing the nature, timing, and extent of substantive procedures.

.04 Assessing control risk below the maximum involves—

- Identifying specific controls relevant to specific assertions.
- Performing tests of controls.
- Concluding on the assessed level of control risk.

.05 The understanding about internal control should be used to identify the types of potential misstatements that could occur and to consider factors that affect the risk of material misstatement. When assessing control risk, controls should be identified that are likely to prevent or detect material misstatement in specific assertions. 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.

.09 General controls relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. The need to identify not only application controls directly related to one or more assertions, but also relevant general controls should be considered.

Performing Tests of Controls

.10 Procedures directed toward evaluating 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. Procedures to obtain such evidential matter ordinarily include—

- Tests performed in previous audits.
- Inquiries of appropriate personnel.
- Inspection of documents, reports, or electronic files.
- Observation of the application of specific controls.

.11 Tests of controls directed toward the effectiveness of the operation of a control are concerned with how the control (whether manual or automated) 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, reports, or electronic files, 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.

.16 In designing tests of automated controls, consider the need to obtain evidence supporting the effective operation of controls directly related to the assertions as well as other indirect controls on which these controls depend. For example, you may identify a "user review of an exception report of credit sales over a customer's authorized credit limit" as a direct control related to an assertion. In such cases, you should consider the effectiveness of the user review of the report and also the controls related to the accuracy of the information in the report (for example, the general controls).

.17 Because of the inherent consistency of IT processing, you may be able to reduce the extent of testing of an automated control. For example, a programmed application control should function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Once you have determined that an automated control is functioning as intended (which could be done at the time the control is initially implemented or at some other date), consider performing tests to determine that the control continues to function effectively. Such tests might include determining that changes to the program are not made without being subject to the appropriate program change controls, that the authorized version of the program is used for processing transactions, and that other relevant general controls are effective. Such tests also might include determining that changes to the programs have not been made, as may be the case when the entity uses packaged software applications without modifying or maintaining them.

.18 To test automated controls, you may need to use techniques that are different from those used to test manual controls. For example, computer-assisted audit techniques may be used to test automated controls or data related to assertions. Also, you may use other automated tools or reports produced by IT to test the operating effectiveness of general controls, such as program change controls, access controls, and system software controls. You should consider whether specialized skills are needed to design and perform such tests of controls.

Documenting the Assessed Level of Control Risk

.19 In addition to the documentation of the understanding of internal control, the auditor should document his or her conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. For those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his or her conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions where the assessed level of control risk is below the maximum level, the auditor should document the basis for his or her conclusion that the effectiveness of the design and operation of controls supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk, the nature of the entity's internal control, and the nature of the entity's documentation of internal control.

Evidence From Prior Audits

.20 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.

.21 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.

.22 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.

.23 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.

.24 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

.25 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

.26 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.

.27 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.

.28 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.

.29 The degree to which you may need to test programmed control activities depends on the effectiveness of computer general control activities, especially the effectiveness of controls over the development of and changes to programs.

[The next page is 4701.]

AAM Section 4700

The Auditor's Assessment of Control Risk

.01 Most of the auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. SAS No. 31, *Evidential Matter*, as amended by SAS No. 48 and 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 (AU section 326), as amended, 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 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*, and SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AU section 319), states 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 No. 55 (AU section 319), as amended, does 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 audit documentation is 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 audit documentation should be modified as needed and is 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. 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:

[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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[The next page is 5101.]

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, and illegal acts that have a direct and material effect on the financial statements.¹
- 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.

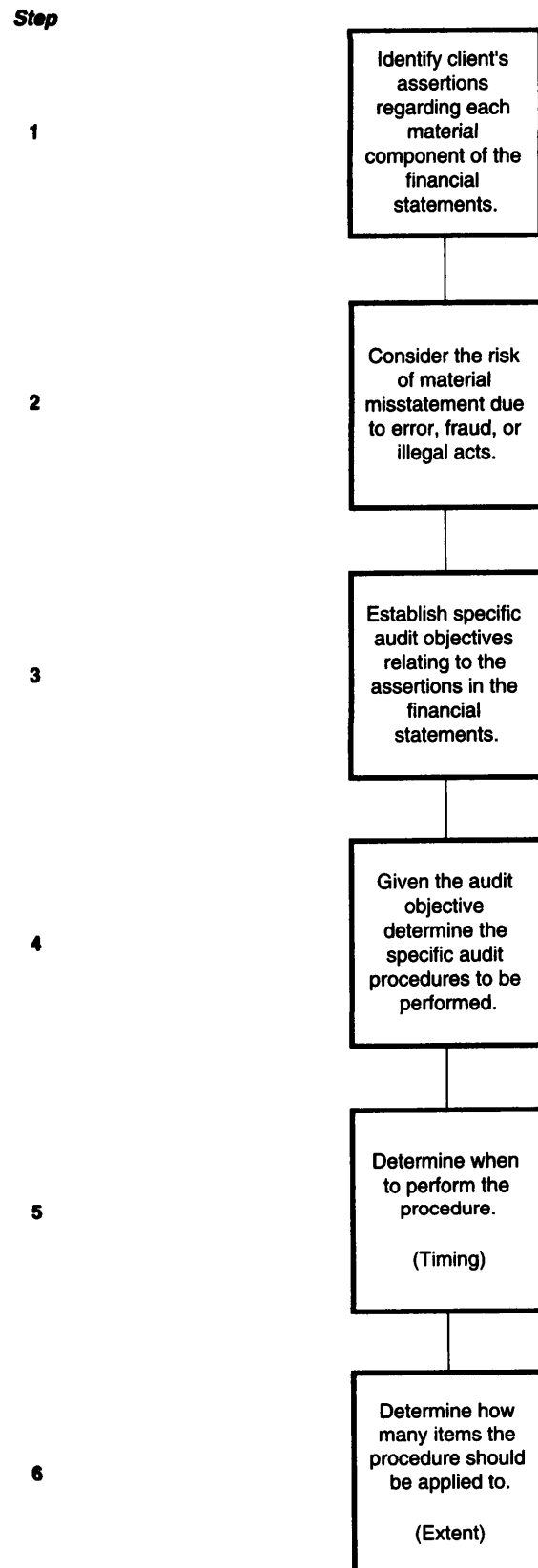
.04 The six steps illustrated in flowchart 1 result in a determination of the nature, timing, and extent of audit tests.

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:

¹ Auditing interpretation No. 1 of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 9312.01-.04), defines a misstatement as something that causes the financial statements not to be in conformity with generally accepted accounting principles (GAAP). Misstatements may consist of (1) difference between the amount, classification, or presentation of a reported financial statement element, account, or item and the amount, classification, or presentation that would have been reported under GAAP, (2) the omission of a financial statement element, account, or item, (3) a financial statement disclosure that is not presented in accordance with GAAP, or (4) the omission of information required to be disclosed in accordance with GAAP.

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 and SAS No. 94 (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. This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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.
- 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 giving consideration to known changes

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, (AU section 326.25) as amended, 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.

[The next page is 5201.]

AAM Section 5200

Timing of Substantive Audit Tests

.01 During the planning stage of the audit, the auditor should consider *when* to apply audit tests. The determination of whether substantive tests can or should be applied prior to year-end is usually based on practical considerations. In making that determination, the auditor evaluates the benefits of performing a substantive test prior to year-end against the potential costs of performing such interim work.

.02 For example, the auditor considers whether the benefits of easing pressures caused by a tight year-end reporting deadline outweigh the cost of gathering additional audit evidence necessitated by the use of a less effective test at an interim date.

.03 Substantive tests can be divided into two categories: those that can generally be applied at an interim date and those that *may be* efficient at an interim date only if certain conditions are met.

.04 If substantive testing is performed at an interim date, roll-forward work should be performed to provide evidence relating to the account balances at the balance-sheet date. In addition, if balances are tested at an interim date, the auditor should:

- Consider whether there are rapidly changing economic conditions that might predispose management to misstate the financial statements in the period after the date tested,
- Compare information concerning the balance at the balance-sheet date with comparable information at the interim date tested to identify unusual amounts,
- Apply additional tests of balances or analytical procedures to provide a reasonable basis for extending the conclusions about the balance at the interim date to the balance at the balance-sheet date, and
- Consider coordinating the tests of interrelated accounts and cutoffs.

Generally balances are tested as of an interim date only when control risk for the related assertions is assessed at below the maximum.

Substantive Tests That Can Generally Be Applied at an Interim Date

.05 Some substantive tests can generally be performed through any date prior to year-end and still be efficient and effective tests. Substantive tests that fall into this category are tests that apply to data readily available prior to year-end. Such tests include:

- a. Substantive tests of transactions to support balance sheet accounts (for example, supporting the details of additions and retirements to a fixed asset account)
- b. Substantive tests of transactions to support income statement accounts (for example, reviewing all charges over a certain dollar amount to the repairs-and-maintenance account)
- c. Analytical procedures that include calculations on an interim basis (for example, comparing actual and budgeted expenses for each month)

.06 In each of these tests, the auditor reviews information that is already available at an interim date. Even if these tests were done at year-end, the same information would be needed and the same procedure performed. Thus, these tests generally can be efficient when performed at an interim date.

.07 For example, auditors frequently support those balance sheet accounts with low activity, such as fixed assets, by analyzing the transactions within the account during the year. Consequently, for property, plant, and equipment the auditor can audit the account by analyzing material additions and retirements rather than by testing the ending balance. To support additions the auditor may vouch material additions to invoices. Vouching such invoices may be performed before year-end without reducing the efficiency or effectiveness of the test. At year-end, the auditor still may have to vouch invoices from the interim date to year-end. However, these invoices would have to be vouched regardless of whether the interim work was performed.

Conditional Substantive Tests

.08 Other substantive tests may be efficient when applied prior to year-end only if certain conditions are met. Generally, such substantive tests should only be applied prior to year-end if substantive tests for the remaining period from the interim date to year-end can be restricted.

.09 SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, “Substantive Tests Prior to the Balance Sheet Date” (AU section 313), describes several factors that should be considered before applying substantive tests to details of balance sheet accounts at interim dates. Those factors relate to the ability to control the additional risk of not detecting errors that may exist at the balance-sheet date when the balance is tested at an interim date. Factors described include:

- a. Whether the effectiveness of the tests will be impaired because of the auditor’s assessment of the control risk
- b. Whether rapidly changing business conditions or circumstances might predispose management to misstate the financial statements between an interim date and year-end
- c. Whether the year-end balances of the particular balance sheet accounts that might be selected for interim testing, are reasonably predictable with respect to amount, relative significance, and composition

.10 In many small business engagements, the cost of bringing the additional risk to an acceptably low level is too great. SAS No. 45 notes that “applying substantive tests . . . at an interim date may not be cost-effective if substantive tests to cover the remaining period cannot be restricted due to the assessment of control risk.” In the case of a small business with limited segregation of duties, these substantive tests are generally not performed at an interim date because to do so would be inefficient. For example, in a small business engagement, the auditor generally audits cash, accounts receivable, inventory, and accounts payable at year-end.

[The next page is 5301.]

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. The AICPA Audit Guide *Audit Sampling* presents recommendations on the application of generally accepted auditing standards to audits involving the use of audit sampling methods, and provides guidance to help auditors apply audit sampling in accordance with SAS No. 39.

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 for the purpose of evaluating some characteristic of an account balance or class of transactions. 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 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 SAS No. 39 contains the following provisions regarding sampling in connection with substantive testing.

- 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 misstated, it is not necessary to examine the items. However, if considering those unexamined items to be misstated would lead to a conclusion that the balance or class contains material misstatement, the auditor should consider alternative 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, projected misstatement results for all audit sampling applications and all known misstatements from nonsampling applications, along with other relevant audit evidence, when evaluating whether the financial statements taken as a whole may be materially misstated (paragraph 30 [AU section 350.30]).

Documentation Requirements

.09 SAS No. 39 contains no specific documentation requirements. However, the documentation standards set forth in the Statements on Auditing Standards dealing with documentation apply to audit sampling applications just as they apply to other auditing procedures. SAS No. 22, *Planning and Supervision* (AU section 311), states that the auditor should prepare a written audit program, and SAS No. 96, *Audit Documentation* (AU section 339), states that audit documentation of tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation should include an identification of the items tested. The identification of the items tested may be satisfied by indicating the source from which the items were selected and the specific selection criteria, for example:

- When a haphazard or random sample is selected, the documentation should include identifying characteristics (for example, the specific invoice numbers of the items included in the sample).
- When all items over a specified dollar amount are selected from a listing, the documentation need describe only the scope and the identification of the listing (for example, all invoices over \$25,000 from the December sales journal).
- When a systematic sample is selected from a population of documents, the documentation need only provide an identification of the source of the documents and an indication of the starting point and the sampling interval (for example, a systematic sample of shipping reports was selected from the shipping log for the period from X to Y, starting with report number 14564 and selecting every 250th report from that point).

With regard to audit sampling applications, the audit program might document such items as the objectives of the sampling application and the audit procedures related to those objectives. Examples of items that the auditor typically documents for tests of controls are discussed in AAM section 5300.25. Examples of items that the auditor typically documents for substantive tests are discussed in AAM section 5300.55.

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.

.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

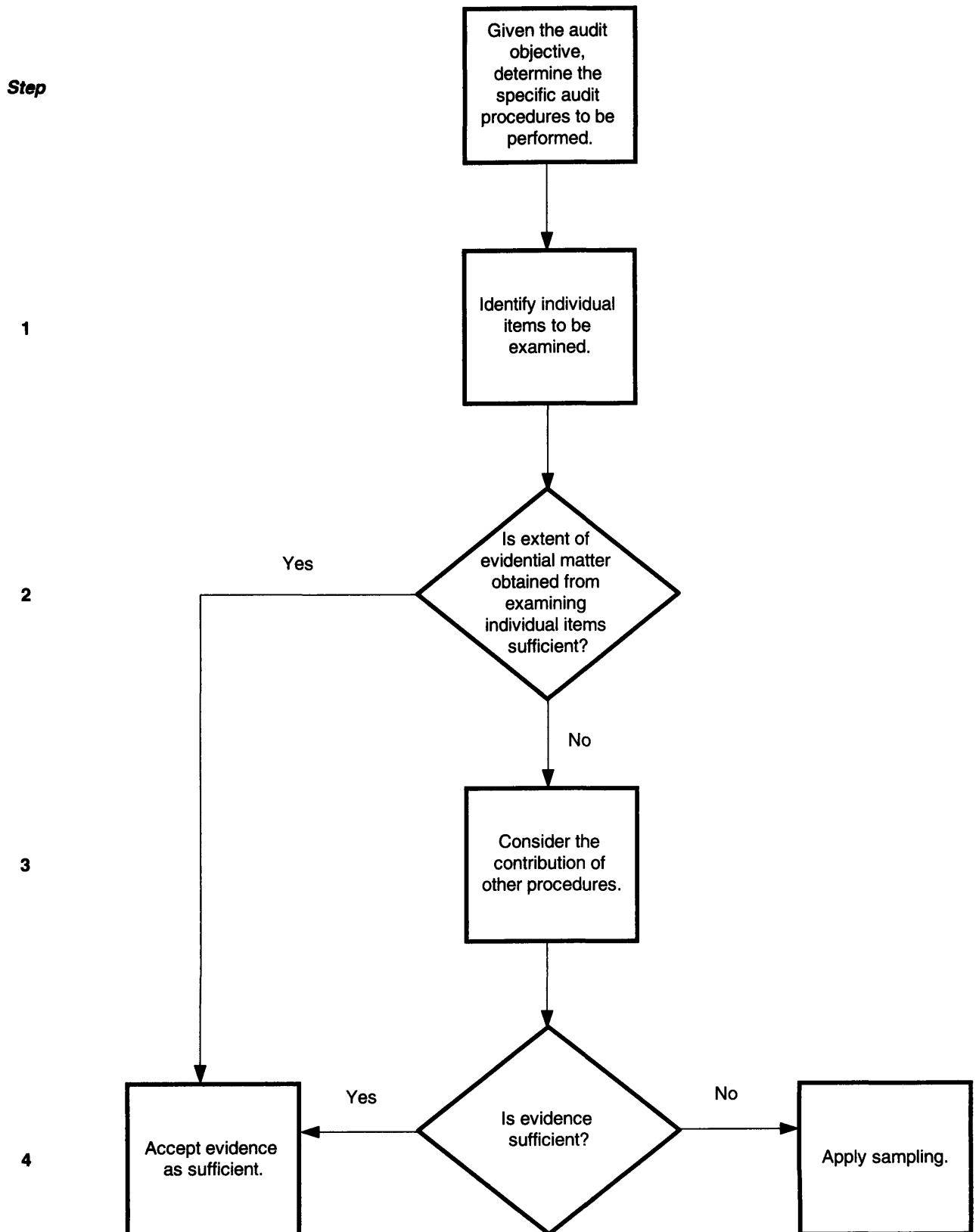
.16 An auditor should apply professional judgment in determining which individual items in an account balance or class of transactions need to be examined. In evaluating individual items, the auditor should consider factors such as size of the item, whether the item is unusual, prior experience with 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 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. 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 tests of controls is to provide evidence about the operating effectiveness and design of controls. Audit sampling for tests of controls is generally appropriate when application of the control leaves documentary evidence of performance. Normally, audit sampling for tests of controls will involve selecting a sample of documents and examining them for evidence that the relevant controls were applied. Tests of controls involving observation of performance of procedures or inquiries of the client are not normally subject to audit sampling.
- 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 a control consists of all the steps the auditor believes are necessary to support the assessed level of control risk. For example, assume that a prescribed control requires that support for every disbursement should include an invoice, a voucher, a receiving report, and a purchase order, all stamped "Paid." The auditor believes that the existence of an invoice and a receiving report, both stamped "Paid," is necessary to indicate adequate performance of the control for purposes of supporting the assessed level of control risk. Therefore, a deviation may be defined as "a disbursement not supported by an invoice and a receiving report that have been stamped 'Paid.'"
- 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 a prescribed control designed to ensure that all shipments were billed, the auditor would not detect deviations by sampling from billed items. An appropriate population for detecting such deviations usually includes the record of all items shipped.
- d. *Defining the period covered by the test.* For samples to be representative of the period under audit, the population generally should include all transactions processed during the period. Often, auditors perform tests of controls during interim work. The auditor should determine what additional evidence needs to be obtained for the remaining period. Often, the auditor obtains the additional evidence by extending the test to the transactions occurring in the remaining period. However, it is not always efficient to include all transactions executed throughout the period under audit in the population to be sampled. In some cases, it might be more efficient to use alternative approaches to test the performance of the control during the remaining period. In these cases the auditor would define the population to include transactions for the period from the beginning of the year to an interim date and consider the following factors in determining what, if any, additional evidence needs to be obtained for the remaining period:
 - The significance of the assertion involved.
 - The specific controls that were tested during the interim period.
 - Any changes in controls from the interim period.

- The extent to which substantive tests were changed as a result of the controls.
- The results of the tests of controls performed during the interim period.
- The length of the remaining period.
- The evidential matter about design or operation that may result from the substantive tests performed in the remaining period.

The auditor selects sampling units from a physical representation of the population. For example, if the auditor defines the population as all customer receivable balances as of a specific date, the physical representation might be a printout of the customer accounts receivable trial balance as of that date. Making selections from a controlled source minimizes differences between the physical representation and the population. The auditor should consider whether the physical representation includes the entire population. If the auditor reconciles the selected physical representation and the population and determines that the physical representation has omitted items in the population that should be included in the overall evaluation, the auditor should select a new physical representation or perform alternative procedures on the items excluded from the physical representation.

- e. *Defining the sampling unit.* The auditor should define the sampling unit in light of the control being tested. A sampling unit may be, for example, a document, an entry, or a line item. An important efficiency consideration in selecting a sampling unit is the manner in which documents are filed and cross-referenced.
- f. *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.
- g. *Determine the sample size.* Sample sizes for tests of controls are affected by (a) the risk of assessing control risk too low, (b) the tolerable rate, (c) the expected population deviation rate, and (d) any effects of small population sizes.

Guidance for determining sample size when performing nonstatistical sampling begins with AAM section 5300.28. A description of statistical sampling begins with AAM section 5300.31.

- h. *Perform the sampling plan.* Once the sample has been selected, the auditor should examine the selected items to determine whether they contain deviations from the prescribed control. If the auditor selects a voided item, and the auditor obtains reasonable assurance that the item has been properly voided and does not represent a deviation from the prescribed control, he or she should replace the voided item. If the auditor selects an unused item, he or she should obtain reasonable assurance that it actually represents an unused item, and not a deviation from the control, and then replace the unused item. If the auditor is unable to examine a selected item because it cannot be located or for any other reason, and the auditor is unable to apply the planned audit procedures or appropriate alternative procedures to selected items, he or she should consider the selected items to be deviations from the controls for purposes of evaluating the sample. In addition, the auditor should consider the reasons for this limitation and the effect that such a limitation might have on his or her understanding of internal control and assessment of control risk.
- i. *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.
- j. *Document the sampling procedure.* Examples of items that the auditor typically documents for tests of controls include the following:

- A description of the prescribed control being tested.
- The definition of the population (the source from which the items were selected) and the sampling unit, including how the auditor considered the completeness of the population.
- The definition of the deviation condition.
- The risk of assessing control risk too low, the tolerable deviation rate, and the expected population deviation rate used in the application.
- The method of sample-size determination.
- The method of sample selection (specific selection criteria).
- A description of how the sampling procedure was performed and a list of the deviations identified in the sample.
- The evaluation of the sample and a summary of the overall conclusion.

.26 Factors Affecting Sample Sizes for Tests of Controls. Sample sizes for tests of controls are affected by the following factors:

- Acceptable risk of assessing control risk too low.* The risk of assessing control risk too low is the risk that the assessed level of control risk based on the sample is less than the true operating effectiveness of the control. Decreasing the risk of assessing control risk too low will increase the sample size.
- Expected population deviation rate.* The expected population deviation rate is an anticipation of the deviation rate in the entire population. As the expected population deviation rate increases, the sample size will increase.
- Tolerable rate.* Tolerable rate is the maximum rate (%) of deviation from a prescribed control that the auditor is willing to accept without altering the planned assessed level of control risk. Higher tolerable rates will permit smaller sample sizes.
- Population size.* The size of the population has little or no effect on the determination of sample size except for very small populations. For example, it is generally appropriate to treat any population of more than 5,000 sampling units as if it were infinite. If the population size is under 5,000 sampling units, the population size may have a small effect on the calculation of the sample size.

.27 The effects of these factors on the appropriate nonstatistical sample size may be summarized as follows:

<i>Factor</i>	<i>General Effect on Sample Size</i>
Risk of assessing control risk too low— increase (decrease)	Smaller (larger)
Tolerable rate—increase (decrease)	Smaller (larger)
Expected population deviation rate— increase (decrease)	Larger (smaller)
Population size	Virtually no effect

.28 Sample Sizes Using Nonstatistical Sampling. The auditor using nonstatistical sampling for tests of controls uses his or her professional judgment to consider the factors described in AAM section 5300.26 in determining sample sizes.

.29 Neither SAS No. 39 nor the Audit Guide *Audit Sampling*, require the auditor to compare the sample size for a nonstatistical sampling application with a corresponding sample size calculated using statistical

theory. Auditors might find it helpful to be familiar with the tables in AAM section 5300.33 through 5300.36. Auditors using these tables as an aid in understanding relative sample sizes for tests of controls will need to apply professional judgment in reviewing the risk levels and expected population deviation rates in relation to sample sizes. Also, an auditor may decide to establish guidelines for sample sizes for tests of controls based on attribute sampling tables. An example of such guidelines is illustrated in the following table:

Sample Sizes for Tests of Controls Based on Attribute Sampling Tables	
<i>Planned Assessed Level of Control Risk</i>	<i>Sample Size</i>
Slightly below the maximum	12–20
Moderate	20–35
Low	30–75

The numbers in the table were determined using a 10 percent risk of assessing control risk too low and an expected population deviation rate of 0 percent. If the auditor finds one or more deviations in the sample, he or she needs to increase the sample size or increase the assessed level of control risk.

.30 After completing the examination of the sampling units and summarizing deviations from prescribed controls, the auditor evaluates the results.

- *Calculate the deviation rate.* Calculating the deviation rate in the sample involves dividing the number of observed deviations by the sample size.
- *Consider sampling risk.* When evaluating a sample for a test of controls, the auditor should consider sampling risk.
- *Consider the qualitative aspects of deviations.* In addition to evaluating the frequency of deviations from pertinent controls, the auditor should consider the qualitative aspects of the deviations.
- *Reach an overall conclusion.* The auditor uses professional judgment to reach an overall conclusion about the effect that the evaluation of the results will have on the assessed level of control risk and on the nature, timing and extent of planned substantive tests.

.31 Sample Sizes Using Statistical Sampling. The appropriate statistical method for tests of controls is attributes sampling, which is a technique designed to estimate qualitative characteristics of a population. Attributes sampling is most commonly used in auditing to test the rate of deviation from a prescribed control to support the auditor's assessed level of control risk.

.32 Applying attributes sampling involves performing the following steps:

- 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.
- 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.
- Specify the following factors:
 - *Acceptable risk of assessing control risk too low.* There is an inverse relationship between the risk of assessing control risk too low and sample size. If the auditor is willing to accept only a low risk of assessing control risk too low, the sample size would ordinarily be larger than if a higher risk were acceptable.
 - *Tolerable rate.* Higher assessments of control risk will permit higher tolerable deviation rates as shown in the following table:

**Relationship Between Tolerable Rates and the Auditor's
Planned Assessed Levels of Control Risk**

<i>Planned Assessed Level of Control Risk</i>	<i>Tolerable Rate</i>
Low	3%–7%
Moderate	6%–12%
Slightly below the maximum	11%– 20%
Maximum	Omit test

- *Expected population deviation rate.* The auditor's expectations may be based on prior year's tests and the control environment. The prior year's results should be considered in light of changes in the entity's internal control and changes in personnel. Sample sizes will increase significantly as the expected population deviation rate increases from zero. If the deviation rate in the sample turns out to be higher than the rate specified by the auditor in determining the sample size, the sample results will not support the auditor's planned assessed level of control risk.
- 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 5300.33 is designed for a risk of assessing control risk too low of 5 percent, and the table in AAM section 5300.34 is designed for a 10 percent risk of assessing control risk too low. With the tolerable rate and the expected population deviation rate, the auditor may find the sample size from the table. The numbers in parentheses are the number of deviations that may be found in the sample and still support the auditor's planned assessed level of control risk.
 - e. *Randomly select the sample from the population.* The section beginning at 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 sample results, along with other relevant evidential matter, support the planned assessed level of control risk, the auditor generally does not need to modify planned substantive tests. If the planned assessed level of control risk is not supported, the auditor would ordinarily either perform tests of other controls that could support the planned assessed level of control risk or increase the assessed level of control risk.
 - i. *Document the Sampling Procedures.* SAS No. 39 and the Audit Guide *Audit Sampling*, do not require specific documentation of audit sampling applications. See AAM section 5300.09 for certain documentation requirements of SAS No. 96. Examples of items that the auditor typically documents for tests of controls are discussed in AAM section 5300.25.

.33

**Statistical Sample Sizes for Test of Controls—
Five Percent Risk of Assessing Control Risk Too Low
(with number of expected errors 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 Guide *Audit Sampling*, New Edition as of April 1, 2001.

Note: This table assumes a large population.

.34

**Statistical Sample Sizes for Test of Controls—
Ten Percent Risk of Assessing Control Risk Too Low
(with number of expected errors in parentheses)**

Expected Population Deviation Rate	Tolerable Rate										
	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	114(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(2)	25(1)	18(1)
2.50	*	*	*	158(4)	110(3)	75(2)	65(2)	58(2)	38(2)	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 Guide *Audit Sampling*, New Edition as of April 1, 2001.

Note: This table assumes a large population.

.35

**Statistical Sampling Results Evaluation
Table for Tests of Controls—
Upper Limits 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	18.3	*	*	*	*	*	*	*
45	6.5	10.2	13.4	16.4	19.2	*	*	*	*	*	*
50	5.9	9.2	12.1	14.8	17.4	19.9	*	*	*	*	*
55	5.4	8.4	11.1	13.5	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	13.6	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	13.6	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	13.2
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 Guide *Audit Sampling*, New Edition as of April 1, 2001.

Note: This table presents upper limits as percentages. This table assumes a large population.

.36

Statistical Sampling Results Evaluation
Table for Tests of Controls—
Upper Limits 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	13.9	15.0
120	2.0	3.3	4.4	5.5	6.6	7.6	8.7	9.7	10.7	11.6	12.6
160	1.5	2.5	3.3	4.2	5.0	5.8	6.5	7.3	8.0	8.8	9.5
200	1.2	2.0	2.7	3.4	4.0	4.6	5.3	5.9	6.5	7.1	7.6

*Over 20 percent.

Derived from AICPA Audit Guide *Audit Sampling*, New Edition as of April 1, 2001.

Note: This table presents upper limits as percentages. This table assumes a large population.

Audit Sampling for Substantive Tests of Details

.37 The purpose of substantive tests of details of transactions and balances is to detect material misstatements in the account balance, transaction class, and disclosure components of the financial statements. An auditor assesses inherent and control risk and relies on a combination of analytical procedures and substantive tests of details for providing a basis for the opinion about whether the financial statements are materially misstated. When testing the details of an account balance or class of transactions, the auditor might use audit sampling to obtain evidence about the reasonableness of monetary amounts.

.38 The auditor uses professional judgment to determine whether audit sampling is appropriate. Sampling may not always be appropriate. For example, the auditor may decide that it is more efficient to test an account balance or class of transactions by applying analytical procedures.

.39 When an auditor plans any audit sampling application, the first consideration is the specific account balance or class of transactions and the circumstances in which the procedure is to be applied. The auditor generally identifies items or groups of items that are of individual significance to an audit objective. For example, an auditor planning to use audit sampling as part of the tests of an inventory balance as well as observing the physical inventory would generally identify items that have significantly large balances or that might have other special characteristics.

.40 The auditor considers all special knowledge about the items constituting the balance or class before designing audit sampling procedures. For example, the auditor might identify 20 items that make up 25 percent of the account balance, and decide that those items should be examined 100 percent and excluded from inventory subject to audit sampling. Any items that the auditor has decided to test 100 percent are not part of the population subject to sampling.

.41 A population for audit sampling purposes does not necessarily need to be an entire account balance or class of transactions. In some circumstances, an auditor might examine all the items that constitute an account balance or class of transactions that exceed a given amount or that have an unusual characteristic; the auditor might either (1) apply other auditing procedures (for example, analytical procedures) to items that do not exceed a given amount or possess an unusual characteristic or (2) apply no auditing procedures to them because there is an acceptably low risk of material misstatement existing in the remaining items.

.42 Once a decision has been made to use audit sampling, the auditor must choose between statistical and nonstatistical sampling. The choice is primarily a cost-benefit consideration. Statistical sampling uses the laws of probability to measure sampling risk. Any sampling procedure that does not measure the sampling risk is a nonstatistical sampling procedure.

.43 *Determining the test objectives.* A sampling plan for substantive tests of details might be designed to (1) test the reasonableness of one or more assertions about a financial statement amount (for example, the existence of accounts receivable) or (2) make an independent estimate of some amount (for example, the last in, first out (LIFO) index for a LIFO inventory). The auditor should carefully identify the characteristic of interest (for example, the misstatement) for the sampling application that is consistent with the audit objective.

.44 *Defining the population.* The population consists of the items constituting the account balance or class of transactions of interest. The auditor should determine that the population from which he or she selects the sample is appropriate for the specific audit objective because sample results can be projected only to the population from which the sample was selected.

.45 *Defining the sampling unit.* A sampling unit is any of the individual elements that constitute the population, and depends on the audit objective and the nature of the audit procedures to be applied. A sampling

unit might be a customer account balance, an individual transaction or an individual entry in a transaction. The auditor might consider which sampling unit leads to a more effective and efficient sampling application in the circumstances.

.46 *Choosing an audit sampling technique.* Either statistical or nonstatistical sampling is appropriate for substantive tests of details. The most common statistical approaches are classical variables sampling and probability-proportional-to-size (PPS) sampling.

.47 *Determining the method of selecting the sample.* The auditor should select the sample in such a way that the sample can be expected to be representative of the population or the stratum from which it is selected.

.48 *Determining the sample size.* Accounting populations tend to include a few very large amounts, a number of moderately large amounts, and a large number of small amounts. Auditors consider the variation in a characteristic when they determine an appropriate sample size for a substantive test, and, generally, the variation of the items' recorded amounts as a means of estimating the variation of the audited amounts of the items in the population. A measure of this variation, or scatter, is called the standard deviation. Sample sizes generally decrease as the variation becomes smaller. Sample sizes for unstratified populations with high variation are generally very large.

.49 In performing substantive tests of details, auditors are also concerned with two aspects of sampling risk:

- a. *Risk of incorrect acceptance*—the risk that the sample supports the conclusion that the recorded account balance is not materially misstated when it is materially misstated.
- b. *Risk of incorrect rejection*—the risk that the sample supports the conclusion that the recorded amount is materially misstated when it is not.

.50 When planning a sample for a substantive test of details, the auditor should consider how much monetary misstatement in the related account balance or class of transactions is acceptable without causing the financial statements to be materially misstated. The maximum monetary misstatement for the balance or class is called tolerable misstatement for the sample. For a particular account balance or class of transactions, the sample size required to achieve the auditor's objective at a given risk of incorrect acceptance increases as the auditor's assessment of tolerable misstatement for that balance or class decreases.

.51 The auditor also assesses the expected amount of misstatement on the basis of his or her professional judgment after considering such factors as the entity's business, the results of prior year's tests of account balances or class of transactions, the results of any pilot sample, the results of any related substantive tests, and the results of any tests of the related controls.

.52 The effect of population size on the appropriate sample size varies according to the audit sampling method used.

.53 *Performing the sampling plan.* The auditor generally should apply auditing procedures appropriate for the particular audit objectives to each sample item.

.54 *Evaluating the sample results.* In evaluating sample results, the auditor should:

- Project the misstatements found in the sample to the population from which the sample was selected and add that amount to the misstatements discovered in any items examined 100 percent.

- Compare the tolerable misstatement for the account balance or class of transactions with the total projected misstatement, adjusted for corrected misstatements. If the total projected misstatement is less than tolerable misstatement for the account balance or class of transactions, the auditor should consider the risk that such a result might be obtained even though the true monetary misstatement for the population exceeds the tolerable misstatement. The auditor should also aggregate the projected misstatement in the balance or class, after adjustments, if any, with other known or likely misstatements in other balances or classes to evaluate whether the financial statements taken as a whole are materially misstated.
- Consider the qualitative aspects of misstatements. If the sample results suggest that the auditor's planning assumptions were in error, appropriate action is taken.

.55 *Documenting the sampling procedure.* SAS No. 39 and the Audit Guide *Audit Sampling*, do not require specific documentation of audit sampling applications. See AAM section 5300.09 for certain documentation requirements of SAS No. 96. Examples of items that the auditor typically documents for substantive tests include:

- The objectives of the test and a description of other audit procedures related to those objectives.
- The definition of the population (the source from which the items were selected) and the sampling unit, including how the auditor determined the completeness of the population.
- The definition of a misstatement.
- The risk of incorrect acceptance, the risk of incorrect rejection, and the tolerable misstatement.
- The audit sampling technique used.
- The method of sample selection (specific selection criteria).
- A description of the performance of the sampling procedures and a list of misstatements identified in the sample.
- The evaluation of the sample and a summary of the overall conclusion.

.56 *Nonstatistical Sampling for Substantive Tests of Details.* Neither SAS No. 39 nor the Audit Guide *Audit Sampling*, require the auditor to compare the sample size for a nonstatistical sampling application with a corresponding sample size calculated using statistical theory. Auditors might find familiarity with sample sizes based on statistical theory helpful when applying professional judgment and experience in considering the effect of various planning considerations on sample size.

.57 The following table "Factors Influencing Sample Sizes for a Substantive Test of Details in Sample Planning" summarizes the effects of various factors on sample sizes for substantive tests of details. (The table is provided only to illustrate the relative effect of different planning considerations on sample size and is not intended as a substitute for professional judgment).

Factors Influencing Sample Sizes for a Substantive Test of Details in Sample Planning

Factors	Conditions Leading to:		Related Factor for Substantive Sample Planning
	Smaller Sample Size	Larger Sample Size	
a. Assessment of inherent risk	Low assessed level of inherent risk	High assessed level of inherent risk	Allowable risk of incorrect acceptance
b. Assessment of control risk	Low assessed level of control risk	High assessed level of control risk	Allowable risk of incorrect acceptance

(continued)

Factors	Conditions Leading to:		Related Factor for Substantive Sample Planning
	Smaller Sample Size	Larger Sample Size	
c. Assessment of risk related to other substantive tests directed at the same assertion (including analytical procedures and other relevant tests of details)	Low assessment of risk associated with other relevant substantive tests	High assessment of risk associated with other relevant substantive tests	Allowable risk of incorrect acceptance
d. Measure of tolerable misstatement for a specific account	Larger measure of tolerable misstatement	Smaller measure of tolerable misstatement	Tolerable misstatement
e. Expected size and frequency of misstatements, or the estimated variance of the population	Smaller misstatements or lower frequency, or smaller population variance	Larger misstatements, higher frequency, or larger population variance	Assessment of population characteristics
f. Number of items in the population	Virtually no effect on sample size unless population is very small		

.58 The following model, based on the statistical theory underlying PPS sampling, illustrates a method of assisting an auditor in gaining an understanding of the relative size of samples for substantive tests of details. The factors presented are based on certain judgments and may differ as auditors' judgments differ in the circumstances. The model illustrates the relative effect of difference planning considerations on sample size only and is not intended as a substitute for professional judgment. (See the AICPA Audit Guide *Audit Sampling*, new edition as of April 1, 2001, paragraphs 5.17–5.22.)

.59 The steps in determining the sample size using this model are:

- a. Consider the level of inherent risk for the particular assertion(s).
- b. Consider the effectiveness of the controls in preventing and detecting material misstatements.
- c. Combine steps *a.* and *b.* using the following categories:
 1. Maximum.
 2. Slightly below minimum.
 3. Moderate.
 4. Low.
- d. Determine tolerable misstatement.
- e. Assess the risk that other substantive procedures designed to test the same assertion will fail to detect a material misstatement in the particular assertion(s).
 1. Maximum
 2. Moderate
 3. Low
- f. Estimate the population's recorded amount after deducting any items that will be examined 100 percent.

- g. Select the appropriate assurance factor from the following table:

Assurance Factors

<i>Assessment of Inherent and Control Risk</i>	<i>Risk That Other Substantive Procedures Will Fail to Detect a Material Misstatement</i>			
	<i>Maximum</i>	<i>Slightly Below Maximum</i>	<i>Moderate</i>	<i>Low</i>
Maximum	3.0	2.7	2.3	2.0
Slightly below maximum	2.7	2.4	2.0	1.6
Moderate	2.3	2.1	1.6	1.2
Low	2.0	1.6	1.2	1.0

Estimate the sample size using the following formula:

$$\text{Population's recorded amount} / \text{Tolerable misstatement} \times \text{Assurance factor} = \text{Sample size}$$

- h. Adjust the sample size estimate to reflect any differences in efficiency between the nonstatistical approach and the statistical approach underlying this model. In practice auditors typically adjust the sample size from 10 percent to 50 percent if the sample is not selected in a statistically efficient manner.

.60 Stratification is particularly important to increasing the efficiency of the sample. If the nonstatistical sample design is planned without stratification, the auditor should increase the sample size. The auditor selects the sample so that it can be expected to be representative of the population from which it has been selected. Before selecting the sample, the auditor generally identifies individually significant items, and may then select the sample from the remaining items using the systematic selection method, which automatically stratifies the sample, or stratify the remaining items into groups and allocate the sample size accordingly.

.61 Evaluating the Sample Results. The misstatement in the sample must be projected to the items from which the sample was selected. One method of projecting the amount of misstatement found in a sample is to divide the amount of misstatement in the sample by the fraction of total dollars in the population included in the sample. For example, if a \$100 misstatement is found in a sample of 10 percent of the population, the projected misstatement would be \$1,000 (\$100/.10).

.62 A second method for projecting the misstatement uses the average difference between the audited and the recorded amounts of each item included in the sample. For example, if \$200 of misstatement is found in a sample of 100 items, the average difference between audited and recorded amounts for items in the sample is \$2 (\$200/100). An estimate of the amount of misstatement in the population may be calculated by multiplying the total number of items in the population (in this case 5,000 items) by the average difference of \$2 for each sample item. The estimate of misstatement in the population is \$10,000 (5,000 × 2).

[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. 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. Conclusion of Audit

1. Perform the following analytical procedures:			
a. Re-examine the comparison of current-period amounts with amounts from prior periods (adjusted for expected changes), 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.) If they are, follow the guidance in paragraphs 76 and 77 of SAS No. 99 (AU section 316.76-.77).	_____	_____	_____
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 5 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, as amended by SAS No. 89 [AU section 333]) and the company's legal representatives.	_____	_____	_____
9. Read the financial statements and related notes and consider the following:			
a. The adequacy of the evidence gathered in response to unusual or unexpected balances identified in planning the audit or in the course of the audit.	_____	_____	_____
b. Unusual or unexpected balances or relationships that were not previously identified.	_____	_____	_____
10. Determine that all applicable disclosure checklists and review programs have been completed. (See Financial Statement Preparation Manual and AAM sections 9200–9500.)	_____	_____	_____
11. Ensure that all work performed has been properly reviewed to determine whether it was adequately performed and to determine whether the results of the work are consistent with the conclusions to be presented in the auditor's report.	_____	_____	_____
12. Ascertain that all working papers have been headed, indexed, cross-referenced, initialed, and dated.	_____	_____	_____
13. Accumulate all pending items in one listing, and dispose of all other follow-up or "TO DO" sheets and any other similar notations in the files.	_____	_____	_____
14. Ascertain that all time has been posted to the daily time control records, and record totals on the engagement time summary. Write explanations for any significant variations between budgeted and actual time.	_____	_____	_____
Note: Some firms include other matters in the general section of programs, such as disposition of proposed adjustments, report preparation and review, reconciliation of actual and estimated time, preparation of fee estimate, evaluation of staff, etc.			
15. Determine that any required communications in accordance with SAS No. 61, <i>Communication With Audit Committees</i> , as amended by SAS No. 89 and SAS No. 90 (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 accounting estimates and, the basis for the auditor's conclusions regarding the reasonableness of management's estimates).	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
d. Audit 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. The auditor should also inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.	_____	_____	_____
e. In connection with each SEC engagement, the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting. The discussion should be open and frank and generally should include such matters as the consistency of the entity's accounting policies and their application, and the clarity and completeness of the entity's financial statements, which include related disclosures. The discussion should also include items that have a significant effect on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.	_____	_____	_____
f. Other information in documents containing audited financial statements.	_____	_____	_____
g. 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.	_____	_____	_____
h. Consultation with other accountants about any accounting or auditing matters.	_____	_____	_____
i. Major issues discussed with management prior to retention (e.g., issues relating to the application of accounting principles and auditing standards).	_____	_____	_____
j. 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. 99 [AU section 316.79-.82] and SAS No. 54 [AU section 317]).	_____	_____	_____

Practice Tip

To help comply with an auditor's communication responsibilities regarding fraud-related matters (SAS No. 99 [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.

Done
by Date W/P
 Ref.

C. Section Completion

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

Done by _____

Reviewed by _____

Fraud Communication Checklist

An auditor may want to complete the checklist below to facilitate compliance with fraud communication requirements.

SAS No. 99 Communication Requirements

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, if applicable, with appropriate level of management.	
4.	If fraud involves senior management, or causes a material misstatement of the financial statements, report the matter directly to the audit committee. ^{1, 2}	
5.	If risks of material misstatement due to fraud that have continuing control implications have been identified, consider whether these risks represent reportable conditions related to the entity's internal control that should be communicated to senior management and the audit committee (See SAS No. 60, <i>Communication of Internal Control Related Matters Noted in an Audit</i> [AU section 325]).	
6.	Consider whether the absence of or deficiencies in programs and controls to mitigate specific risks of fraud or to otherwise help prevent, deter, and detect fraud represent reportable conditions that should be communicated to senior management and the audit committee.	
7.	Consider communicating other risks of fraud identified as a result of the assessment of the risks of material misstatements due to fraud.	
8.	Consider whether a duty to disclose possible fraud to parties outside the entity exists in the following circumstances: a. To comply with certain legal and regulatory requirements. b. To a successor auditor when the successor makes inquiries in accordance with SAS No. 84, <i>Communications Between Predecessor and Successor Auditors</i> (AU section 315). ³ c. In response to a subpoena. d. To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance.	

¹ In addition, the auditor should reach an understanding with the audit committee regarding the nature and extent of communications with the committee about misappropriations perpetrated by lower-level employees.

- ² If the perpetrator controls the audit committee or board of directors, you should obtain legal advice and you may need to communicate directly with the client's legal counsel. If the perpetrator is a general partner acting against the interests of limited partners, you should obtain legal advice and consider communicating with the limited partners. If the perpetrator is the owner-manager of a small business, you may have little choice but to communicate with the perpetrator and withdraw from the engagement. However, first consult with legal counsel.
- ³ Because potential conflicts between the auditor's ethical and legal obligations for confidentiality of client matters may be complex, the auditor may wish to consult with legal counsel before discussing possible fraud matters with parties outside the client.

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>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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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 Systems, 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/> Note: Ordinarily, audit planning does not require an understanding of the control activities related to every account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them. <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-			

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ing electronic means (such as computers, electronic commerce, 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.	_____	_____	_____
10. As part of the understanding of internal control sufficient to plan the audit, evaluate whether entity programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation. (Entity programs and controls intended to address the risks of fraud may be part of any of the five components of internal control.) These programs and controls may involve (a) specific controls designed to mitigate specific risks of fraud—for example, controls to address specific assets susceptible to misappropriation, and (b) broader programs designed to prevent, deter, and detect fraud—for example, programs to promote a culture of honesty and ethical behavior.	_____	_____	_____
11. Consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies may exacerbate the risks. The exhibit at the end of SAS No. 99 (AU section 316), discusses examples of programs and controls an entity might implement to create a culture of honesty and ethical behavior, and that help to prevent, deter, and detect fraud.	_____	_____	_____
12. Consider the evaluation conducted in accordance with steps 10 and 11 when assessing the risks of material misstatement due to fraud.	_____	_____	_____
13. Address the risk of management override of controls by performing the required procedures stated in paragraphs 58 through 67 of SAS No. 99 (AU section 316.58–.67).	_____	_____	_____

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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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 determine 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 evidential matter to support this assessed level of control risk. Some examples of evidential matter which can be used to support this assessed level are shown in section B-2, below—Tests of Controls. | _____ | _____ | _____ |

Remember: Assessing control risk and choosing an audit strategy is made at the assertion level, not a global level. A primarily substantive testing approach may be chosen for some assertions, while less rigorous substantive tests may be performed for other assertions due to a less than maximum control risk assessment.

- | | | | |
|--|-------|-------|-------|
| 3. Based on the assessed level of control risk the timing and extent of substantive tests may be affected. Consider the following matters as appropriate. Cross-reference to AAM section 5400.060. | | | |
| a. The use of confirmations. | _____ | _____ | _____ |
| b. If confirmations are used: | | | |
| (1) Extent and method of selection of accounts for confirmation. | _____ | _____ | _____ |
| (2) Use of positive or negative forms of confirmation request, or a combination of both. | _____ | _____ | _____ |
| (3) Timing of confirmation procedures. | _____ | _____ | _____ |
| (4) Type of information needed on the confirmation request. | _____ | _____ | _____ |
| (5) Anticipated scope of alternative procedures as to significant accounts which do not respond to confirmation requests. | _____ | _____ | _____ |

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
c. Nature and extent of tests to substantiate sales cut-off.	_____	_____	_____
d. Nature and extent of tests to substantiate deferral and realization of revenue in such situations as unearned subscription income or unearned finance charges on installment receivables.	_____	_____	_____
e. Approach to reviewing and evaluating adequacy of the allowance provided for doubtful accounts (review of allowances for specific accounts, comparison of experience relating to write-offs with sales and receivables, and the client's past and present credit policies and practices, etc.).	_____	_____	_____

B-2. Revenues, Receivables, and Receipts—Tests of Controls

Note: Tests directed toward the effectiveness of the operation of a control are concerned with how the control (whether manual or automated) 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 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. _____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.).
 - 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 determine whether those controls 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.

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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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.

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 (whether manual or automated) 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.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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).	_____	_____	_____
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>Note: The working paper format for this step would present reconciliations of total receipts and disbursements per cash books to the respective total credits and charges per the bank statement(s) in addition to reconciliations of the bank and book balances at the beginning and end of the selected period. This working paper format may be used to reconcile total activity per the cash books and bank statements for various time periods such as a month or several months.</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	_____	_____	_____

Done
by

Date

W/P
Ref.

C-3. Purchases, Accounts Payable, and Disbursements—Evaluation of Tests of Controls

1. Evaluate whether the assessed level of risk was appropriate based on the results of the tests of controls and:
- a. Document matters considered and conclusions reached in making the control risk assessment in accordance with firm policy (completion of questionnaires, checklists, preparation of required memoranda, etc.).

b. Based on the control risk assessment, make necessary modifications to applicable sections of the program for substantive tests.

c. Identify and note reportable conditions in internal control to be brought to the client's attention.

d. Identify and note other internal control matters to be brought to the client's attention.

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

Practice Tip

When performing tests of controls, caution is necessary. The tests cannot support an assessment of control risk below the maximum unless they provide evidence to evaluate the effectiveness of design and operation of controls. See AAM section 4600.15.

D-1. Payroll—Understanding and Risk Assessment

1. Obtain and document a sufficient understanding of the design of relevant controls which relate to the payroll account balances and transactions and determine 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.

_____	_____	_____
_____	_____	_____
_____	_____	_____

Remember: Assessing control risk and choosing an audit strategy is made at the assertion level, not a global level. A primarily substantive testing approach made be chosen for some assertions, while less rigorous substantive tests may be performed for other assertions due to a less than maximum control risk assessment.

3. Based on the assessed level of control risk the timing and extent of substantive tests may be affected. Consider the following matters as appropriate. Cross-reference to AAM section 5400.160.
 - a. The extent to which analytical procedures are applied to payroll costs and expenses and the extent to which fluctuations are investigated.
 - b. Whether, and to what extent, gross pay is reconciled to individual earnings records.
 - c. Whether, and to what extent, a payoff is made.
 - d. The extent to which labor charges to property and equipment and to inventory are tested.
 - e. The extent to which payroll taxes withheld and accrued are tested.

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

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 determine 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.)

_____	_____	_____
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	<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/> Remember: Assessing control risk and choosing an audit strategy is made at the assertion level, not a global level. A primarily substantive testing approach made be chosen for some assertions, while less rigorous substantive tests may be performed for other assertions due to a less than maximum control risk assessment. <hr/>			
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

<hr/> 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. <hr/>			
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.	_____	_____	_____
Note: This testing may be coordinated with tests of controls for purchases, payables, and disbursements, and for revenues, receivables, and receipts.			
3. Obtain an analysis of overhead costs charged to inventories and over- or under-absorbed overhead. Review the amounts included in the overhead pool for propriety and perform the following:			
a. Determine that overhead costs are being charged to inventory in accordance with an appropriate policy (for example, as a percent, as a percent of direct labor).	_____	_____	_____
b. Identify disposition of variances, if any, between actual overhead costs incurred and overhead costs applied to production and inventory. Determine that variances are reasonable. Determine that no excessive costs for idle plant are being charged to inventory.	_____	_____	_____
4. If a job order cost system is used, obtain the job order ledger (or tabulation), select a period(s) and perform the following:			
a. Trace total costs incurred to the voucher register (or cash disbursements journal), the payroll distribution, and support for overhead applied.	_____	_____	_____
b. Test the footings of the job order ledger by refooting the detail for selected subtotals and refooting the subtotals.	_____	_____	_____
c. Select ____ job orders for jobs in process and completed jobs and perform the following:			
(1) Examine authorization for the job order.	_____	_____	_____
(2) Trace materials used on a test basis at various times since inception of the job order to such supporting details as requisitions, purchase orders, receiving reports, and processed invoices. (Consider coordination with compliance tests for purchases.)	_____	_____	_____
(3) Trace direct labor costs to account distributions of the payroll registers and on a test basis to individual time			

	<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	_____	_____	_____
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.**III. Cash****Financial Statement Assertions:**

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

Objectives:

- A. Existence of cash—To determine that cash exists and is owned by the entity. (Assertions 1 and 3)
- B. Proper cut-off—To determine that cash balances reflect a proper cut-off of cash receipts and disbursements. (Assertions 1, 2, and 4)
- C. Cash complete—To determine that cash balances as presented in the balance-sheet properly reflect all cash and cash items on hand, in transit, or on deposit with third parties. (Assertions 1, 2, and 5)
- D. Proper classification—To determine that cash balances are properly classified in the financial statements and any restrictions on the availability of funds are properly disclosed. (Assertions 3 and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:**A. Preliminary Procedures**

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:
 - a. Preliminary analytical review

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
b. Internal control documentation, control risk assessment, and control test results	_____	_____	_____
c. Assessment of risk of material misstatement	_____	_____	_____
d. Other planning documents and risk assessments	_____	_____	_____
2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<p>Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.</p>			
[A] B. Substantive Analytical Procedures			
[B] [C] [D]			
1. Compare account balances with expected amounts and investigate any significant deviations from expected amounts.	_____	_____	_____
2. Compute quick current ratios (cash, and net receivables) and compare with expected ratios. Investigate any significant deviations from the expected ratios.	_____	_____	_____
C. Cash in Banks—Detailed Tests			
A C D			
1. Confirm bank balances (using standard forms to confirm account balance information with financial institutions) as of the balance-sheet date for _____ bank accounts used during the year. (Confirmation of and information about certificates of deposit and compensating balances arrangements should also be requested.)	_____	_____	_____
B [C]			
2. Arrange to obtain cut-off bank statements and related paid checks directly from the banks for _____ days following the balance-sheet date.	_____	_____	_____
C			
3. Obtain or prepare a comparative listing of the component bank account(s) and petty cash fund balances as of the closing and opening balance-sheet dates for the year (period) being audited:			
a. Refoot the schedule and trace totals to the financial statement assembly sheets.	_____	_____	_____
b. Trace closing balances to the general ledger and working papers on bank reconciliations and petty cash funds.	_____	_____	_____
c. Trace opening balances to the working papers for the preceding audit.	_____	_____	_____
d. For bank accounts opened and closed during the year (period) trace to authorization in the minutes of the board of directors meetings.	_____	_____	_____

<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 replies:			
	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.	_____	_____	_____
D. Cash Funds and Petty Cash—Detailed Tests				
	1. The auditor should consider performing the following procedures if cash balances on hand are deemed significant:			
A B C D	a. Identify all funds, including locations, custodians, amounts and purpose and decide:			
	(1) Which funds are to be counted and, if so, whether to count them simultaneously and whether simultaneous			

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A B C D	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.	_____	_____	_____
	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)

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
F. Section Completion			
1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for cash balances, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for cash balances.	_____	_____	_____
2. The objectives of this audit program have been met.	_____	_____	_____
This audit program section has been completed in accordance with firm policy.			
_____	_____	_____	_____
Done by	_____	_____	_____
_____	_____	_____	_____
Reviewed by	_____	_____	_____

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Done By	Date	W/P Ref.
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IV. Investments in Securities, Derivatives, Hedging Activities, and Transfers of Financial Assets

(Note: This program is based on Statement on Auditing Standards (SAS) No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AU section 332), and its companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. We have redesigned this program to reflect the requirements and style of SAS No. 92 and its companion Audit Guide. Refer to the SAS and its companion Audit Guide for authoritative guidance on auditing investments in securities, derivatives, and hedging activities.)

Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.

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, control risk assessment, and control test results
 - c. Assessment of risk of material misstatement
 - d. Other planning documents and risk assessments
2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.
3. (Some of the following information may not be necessary, depending upon the judgment of the auditor.) Obtain or prepare detailed analyses of the client's securities and derivatives. The analyses may contain the following information:
 - a. Classification between held-to-maturity, available-for-sale, or trading securities, and securities accounted for under other methods (for example, the equity method).

	_____	_____	_____
	_____	_____	_____
	_____	_____	_____
	_____	_____	_____
	_____	_____	_____

	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
b. Description of the security or derivative, including any interest rate and maturity of debt, the dividend rate, etc.	_____	_____	_____
c. Classification between current and noncurrent portfolios.	_____	_____	_____
d. Balances at the end of the preceding period.	_____	_____	_____
e. Additions during the current period including dates, number of shares, etc.	_____	_____	_____
f. Sales and dispositions during the current period including dates, proceeds, realized gain or loss, etc.	_____	_____	_____
g. Balances at the end of the current period.	_____	_____	_____
h. Amounts of unrealized appreciation and depreciation at the end of the current period.	_____	_____	_____
i. Investment income (interest, dividends, etc.) earned during the current period, collected during the current period, accrued at the end of the current period, and accrued at the end of the preceding period.	_____	_____	_____
4. Foot and crossfoot the analyses.	_____	_____	_____
5. Trace ending totals to the general ledger and trace opening balances to the preceding period audit workpapers.	_____	_____	_____
B. Evaluating Managements' Intent and Ability			
1. In evaluating management's intent and ability—			
a. Obtain an understanding of the process used by management to classify securities as trading, available-for-sale, or held-to-maturity. Determine that the client's securities are classified in accordance with generally accepted accounting principles.	_____	_____	_____
b. For an investment accounted for using the equity method, inquire of management as to whether the entity has the ability to exercise significant influence over the operating and financial policies of the investee and evaluate the attendant circumstances that serve as a basis for management's conclusions.	_____	_____	_____
c. If the client accounts for the investment contrary to the presumption established by generally accepted accounting principles for use of the equity method, 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 that presumption.	_____	_____	_____
d. Consider whether management's activities corroborate or conflict with its stated intent. For example, evaluate an assertion that management intends to hold debt securities to their maturity by examining evidence such as documentation of management's strategies and sales and other historical activities with respect to those securities and similar securities.	_____	_____	_____

	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
e. Determine whether generally accepted accounting principles require management to document its intentions and specify the content and timeliness of that documentation. Inspect the documentation and obtain evidential matter about its timeliness. Unlike the formal documentation required for hedging activities, evidential matter supporting the classification of debt and equity securities may be more informal.	_____	_____	_____
f. Determine whether management's activities, contractual agreements, or the client's financial condition provide evidence of its ability.	_____	_____	_____
C. Financial Statement Assertion: Existence or Occurrence			
1. Confirm existence of securities with <u>issuers</u> .	_____	_____	_____
2. Confirm existence of securities, including securities in electronic form, with <u>holders</u> or with the counterparty to the derivative.	_____	_____	_____
3. Confirm settled transactions with the broker-dealer or counterparty.	_____	_____	_____
4. Confirm unsettled transactions with the broker-dealer or counterparty.	_____	_____	_____
5. Physically inspect the security or derivative contract.	_____	_____	_____
6. Read the executed partnership or similar agreements.	_____	_____	_____
7. Inspect underlying agreements and other forms of supporting documentation, in paper or electronic form, for—			
a. Amounts reported.	_____	_____	_____
b. Evidence that would preclude the sales treatment of a transfer.	_____	_____	_____
c. Unrecorded repurchase agreements.	_____	_____	_____
8. Inspect supporting documentation for subsequent realization or settlement after the end of the reporting period.	_____	_____	_____
9. Trace payments for purchases of securities and derivatives to canceled checks.	_____	_____	_____
10. Perform substantive analytical procedures.	_____	_____	_____
11. If a response to a positive confirmation request is not received, apply alternative procedures. (Alternative procedures may include examining source documents, such as invoices or broker's statements; inspecting executed agreements; examining cash receipts or disbursements subsequent to year end).	_____	_____	_____
D. Financial Statement Assertion: Completeness			
1. Request the counterparty to a derivative or the holder of a security to provide information about it, such as whether there are any side agreements or agreements to repurchase securities sold.	_____	_____	_____
2. Request counterparties or holders who are frequently used, but with whom the accounting records indicate there are presently no derivatives or securities, to state whether they are counterparties to derivatives with the client or holders of its securities.	_____	_____	_____

	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
3. Inspect financial instruments and other agreements to identify embedded derivatives.	_____	_____	_____
4. Inspect documentation in paper or electronic form for activity subsequent to the end of the reporting period.	_____	_____	_____
5. Perform substantive analytical procedures.	_____	_____	_____
6. Compare previous and current account detail to identify assets that have been removed from the accounts and test those items further to determine that the criteria for sales treatment have been met.	_____	_____	_____
7. Read other information, such as minutes of meetings of the board of directors or finance, asset/liability, investment, or other committees.	_____	_____	_____

Note: If one or more service organizations provide services that are part of the client's information system for derivatives, the auditor may be unable to sufficiently limit audit risk for assertions about the completeness of derivatives without obtaining evidential matter about the operating effectiveness of controls at one or more of the service organizations.

E. Financial Statement Assertion: Rights and Obligations

1. Confirm significant terms with the counterparty to a derivative or the holder of a security, including the absence of any side agreements.	_____	_____	_____
2. Inspect underlying agreements and other forms of supporting documentation, in paper or electronic form.	_____	_____	_____
3. Consider whether the findings of other auditing procedures, such as reviewing minutes of meetings of the board of directors and reading contracts and other agreements provide evidence about rights and obligations, such as pledging of securities as collateral or selling securities with a commitment to repurchase them.	_____	_____	_____

F. Financial Statement Assertion: Valuation

I. Valuation Based on Cost

1. Inspect documentation of the purchase price.	_____	_____	_____
2. Confirm the purchase price with the issuer or holder.	_____	_____	_____
3. Test discount or premium amortization, either by recomputation or analytical procedures.	_____	_____	_____
4. Evaluate management's conclusion about the need to recognize an impairment loss for a decline in the security's fair value below its cost that is other than temporary.	_____	_____	_____

II. Valuation Based on an Investee's Financial Results (Including but not limited to the equity method of accounting)

1. Obtain sufficient evidence in support of the investee's financial results.	_____	_____	_____
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	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
2. Read available financial statements of the investee and the accompanying audit report, if any. (Financial statements of the investee that have been audited by an auditor whose report is satisfactory, for this purpose, to the investor's auditor may constitute sufficient evidential matter.)	_____	_____	_____
3. Review information in the investor's files that relates to the investee such as investee minutes and budgets and cash flows information about the investee.	_____	_____	_____
4. Make inquiries of investor management about the investee's financial results.	_____	_____	_____
5. If the investee's financial statements are not audited, or if the investee auditor's report is not satisfactory to the investor's auditor for this purpose, apply, or request that the investor arrange with the investee to have another auditor apply, appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor.	_____	_____	_____
6. If the carrying amount of the security reflects factors that are not recognized in the investee's financial statements or fair values of assets that are materially different from the investee's carrying amounts, obtain sufficient evidence in support of these amounts.	_____	_____	_____
7. If a time lag between the date of the client's financial statements and those of the investee has a material effect on the client's financial statements, determine whether the client's management has properly considered the lack of comparability.	_____	_____	_____
8. Evaluate management's conclusion about the need to recognize an impairment loss for a decline in the security's fair value below its carrying amount that is other than temporary.	_____	_____	_____
9. 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 investor auditor's report, read available interim financial statements of the investee and make appropriate inquiries of the investor to identify subsequent events and transactions that are material to the investor's financial statements.	_____	_____	_____
10. Obtain evidence relating to material transactions between the client and the investee to evaluate the propriety of the elimination of unrealized profits and losses on transactions between the client and the investee that is required when the equity method of accounting is used to account for an investment under generally accepted accounting principles.	_____	_____	_____
11. Obtain evidence relating to material transactions between the client and the investee to evaluate the adequacy of disclosures about material related party transactions.	_____	_____	_____

	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
III. Valuation Based on Fair Value			
1. Determine whether generally accepted accounting principles specify the method to be used to determine the fair value of the client's derivatives and securities and evaluate whether the determination of fair value is consistent with the specified valuation method.	_____	_____	_____
2. Evaluate whether the entity's method for determining fair value measurements is applied consistently and if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity, or changes in accounting principles.	_____	_____	_____
3. If management has changed the method for determining fair value, consider whether management can adequately demonstrate that the method to which it has changed provides a more appropriate basis of measurement or whether the change is supported by a change in the GAAP requirements or a change in circumstances.	_____	_____	_____
4. Consider the guidance in SAS No. 101, <i>Auditing Fair Value Measurements and Disclosures</i> (AU section 328), and if the determination of fair value requires the use of estimates, consider the guidance in SAS No. 57, <i>Auditing Accounting Estimates</i> (AU section 342).	_____	_____	_____
5. If applicable, obtain evidence about an client's derivatives and securities from quoted market prices listed on national exchanges or over-the-counter markets.	_____	_____	_____
6. If applicable, obtain evidence about a client's derivatives and securities from quoted market prices obtained from broker-dealers who are market makers in them or through the National Quotation Bureau. (Using such a price quote to test valuation assertions may require special knowledge to understand the circumstances in which the quote was developed.)	_____	_____	_____
7. If quoted market prices are not available for the derivative or security, obtain estimates of fair value from broker-dealers or other third-party sources based on proprietary valuation models or from the client based on internally or externally developed valuation models.	_____	_____	_____
8. Obtain an understanding of the method used by the broker-dealer, other third-party source, or by the client, in developing the estimate, and evaluate whether the method of measurement is appropriate in the circumstances.	_____	_____	_____
9. If necessary, obtain estimates from more than one pricing source. (Examples of why this may be necessary include: (1) the pricing source has a relationship with the client that might impair its objectivity, such as an affiliate or a counterparty involved in selling or structuring the product, and (2) the valuation is based on assumptions that are highly subjective or particularly sensitive to changes in the underlying circumstances.)	_____	_____	_____

	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
10. For fair-value estimates obtained from broker-dealers and other third-party sources, consider the applicability of the guidance in SAS No. 73, <i>Using the Work of a Specialist</i> (AU section 336), or SAS No. 70, <i>Service Organizations</i> (AU section 324).	_____	_____	_____
11. If using the work of a specialist in auditing fair value measurements, determine whether the specialist's understanding of the definition of fair value and the method used to determine fair value are consistent with those of management and with GAAP through discussions with the specialist or by reading the specialist's report.	_____	_____	_____
12. If a derivative or security is valued by the client using a valuation model, obtain evidence supporting management's assertions about fair value by performing the following procedures, as deemed necessary. (A valuation model should not be used to determine fair value when generally accepted accounting principles require the fair value of a security be determined using quoted market prices.)			
a. Assess the reasonableness and appropriateness of the model. Determine that the valuation model is appropriate for the derivative or security to which it is applied and whether the assumptions used are reasonable and appropriately supported. (The evaluation of the appropriateness of valuation models and each of the assumptions used in the models may require considerable judgment and knowledge of valuation techniques, market factors that affect value, and actual and expected market conditions, particularly in relation to similar derivatives and securities that are traded. Accordingly, the auditor may consider it necessary to involve a specialist in assessing the model.)	_____	_____	_____
b. Evaluate the source and reliability of evidence supporting management's assumptions, including consideration of the assumptions in light of historical and market information.	_____	_____	_____
c. Evaluate whether management used relevant information that was reasonably available at the time.	_____	_____	_____
d. Consider the sensitivity of the valuation to changes in significant assumptions, including market conditions that may affect the value.	_____	_____	_____
e. Consider whether management has identified the significant assumptions and factors influencing the measurement of fair value.	_____	_____	_____
f. Where assumptions are reflective of management's intent and ability to carry out specific courses of action, consider whether they are consistent with the entity's plans and past experience.	_____	_____	_____
g. If management relies on historical financial information in the development of assumptions, consider the extent to which such reliance is justified.	_____	_____	_____
h. Test the data used to develop the fair value measurements and disclosures and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions.	_____	_____	_____

	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
i. If necessary, calculate the value, for example using a model developed by the auditor or by a specialist engaged by the auditor, to develop an independent expectation to corroborate the reasonableness of the value calculated by the client. Take into consideration all significant variables and evaluate any significant difference from management's estimate.	_____	_____	_____
j. If using a subsequent event or transaction to substantiate a fair value measurement, consider only those events or transactions that reflect circumstances existing at the balance-sheet date.	_____	_____	_____

Practice Tip

It may be useful to perform sensitivity analysis on key factors to determine how they affect the estimate of the fair value. For example, when an estimate of the fair value of a non-exchange-traded option includes an assumption about the volatility of the underlying security, the auditor may perform an analysis to determine how the fair value of the option will differ if that volatility is changed. The results of this analysis will help the auditor determine which factors and assumptions have the most significant impact on the estimate.

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|---|-------|-------|-------|
| 13. In situations requiring considerable judgment, consider the guidance in SAS No. 57, <i>Auditing Accounting Estimates</i> (AU section 342), and SAS No. 73, <i>Using the Work of a Specialist</i> (AU section 336). | _____ | _____ | _____ |
| 14. If collateral, such as negotiable securities, real estate, chattels, or other property, is an important factor in evaluating fair value and collectibility of a security, obtain evidence regarding the existence, fair value, and transferability of such collateral as well as the investor's rights to the collateral. | _____ | _____ | _____ |
| 15. Evaluate management's conclusion about the need to recognize in earnings an impairment loss for a decline in fair value that is other than temporary. | _____ | _____ | _____ |
| 16. Gather evidential matter to support the amount of unrealized appreciation or depreciation in the fair value of a derivative that is recognized in earnings or other comprehensive income or that is disclosed because of the ineffectiveness of a hedge. (That requires an understanding of the methods used to determine whether the hedge is highly effective and to determine the ineffective portion of the hedge.) | _____ | _____ | _____ |
| 17. Evaluate the sufficiency and competence of the audit evidence obtained from auditing fair value measurements and disclosures as well as the consistency of that evidence with other audit evidence obtained and evaluated during the audit. | _____ | _____ | _____ |
| 18. Determine that the audit committee is informed about the process used by management in formulating fair value estimates, and about the conclusions regarding the reasonableness of those estimates. | _____ | _____ | _____ |

IV. Impairment Losses

1. Evaluate (a) whether management has considered relevant information in determining whether factors, such as those listed below, exist and (b) management's conclusions about the need to recognize an impairment loss.

	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
a. Fair value is significantly below cost and—			
(1) The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.	_____	_____	_____
(2) The decline has existed for an extended period of time.	_____	_____	_____
(3) Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.	_____	_____	_____
b. The security has been downgraded by a rating agency.	_____	_____	_____
c. The financial condition of the issuer has deteriorated.	_____	_____	_____
d. Dividends have been reduced or eliminated, or scheduled interest payments have not been made.	_____	_____	_____
e. The client recorded losses from the security subsequent to the end of the reporting period.	_____	_____	_____
2. Obtain evidence about such factors that tend to corroborate or conflict with management's conclusions.	_____	_____	_____
3. If the client has recognized an impairment loss, gather evidence supporting the amount of the impairment adjustment recorded and determine whether the client has appropriately followed generally accepted accounting principles.	_____	_____	_____
4. If the client has recognized an impairment loss and there is agreement with that conclusion:			
a. Determine that the write-down of an investment to a new cost basis is accounted for as a realized loss.	_____	_____	_____
b. Test the calculation of the loss recorded.	_____	_____	_____
c. Determine that the new cost basis of investments previously written down is not changed for subsequent recoveries in fair value.	_____	_____	_____
d. Review a summary of investments written down for completeness and unusual items.	_____	_____	_____
e. Assess the credit rating of the counterparty.	_____	_____	_____
f. Conclude on the adequacy of impairment adjustments recorded.	_____	_____	_____
G. Financial Statement Assertion: Presentation and Disclosure			
1. Evaluate whether the presentation and disclosure of derivatives and securities are in conformity with generally accepted accounting principles.	_____	_____	_____
2. In evaluating the adequacy of presentation and disclosure, consider the form, arrangement, and content of the financial statements and their notes, including, for example, the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts reported.	_____	_____	_____
3. If an item contains a high degree of measurement uncertainty, assess whether the disclosures are sufficient to inform users of such uncertainty.	_____	_____	_____

	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
4. When disclosure of fair value information under GAAP is omitted because it is not practicable to determine fair value with sufficient reliability, evaluate the adequacy of disclosures required in those circumstances, or whether the financial statements are materially misstated.	_____	_____	_____
5. Follow the guidance in SAS No. 32, <i>Adequacy of Disclosure in Financial Statements</i> (AU section 431), in evaluating the adequacy of disclosure that is not specifically required by generally accepted accounting principles.	_____	_____	_____

H. Other Procedures

1. Test accrued interest on investment securities as follows:			
a. Obtain or prepare a trial balance of accrued interest receivable on securities and derivatives and agree to the general ledger.	_____	_____	_____
b. Recalculate accrued interest for selected securities and derivatives.	_____	_____	_____
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.	_____	_____	_____
2. Determine that gains or losses on dispositions of securities and derivatives have been computed and accounted for properly.	_____	_____	_____
3. Trace proceeds from sales of securities and derivatives to entries in cash book.	_____	_____	_____
4. Determine that any transfers between categories of investments have been properly made and recorded in accordance with generally accepted accounting principles.	_____	_____	_____

I. Hedging Activities

1. Gather evidential matter to determine whether management complied with the hedge accounting requirements of generally accepted accounting principles, including designation and documentation requirements.	_____	_____	_____
2. Gather evidential matter to support management's expectation at the inception of the hedge that the hedging relationship will be highly effective and its periodic assessment of the ongoing effectiveness of the hedging relationship as required by generally accepted accounting principles.	_____	_____	_____
3. In situations where the client designates a derivative as a fair value hedge, and the client adjusts the carrying amount of the hedged item for the change in the hedged item's fair value that is attributable to the hedged risk, gather evidential matter supporting the recorded change in the hedged item's fair value that is attributable to the hedged risk.	_____	_____	_____

	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
4. Gather evidential matter to determine whether management has properly applied generally accepted accounting principles to the hedged item.	_____	_____	_____
5. For a cash flow hedge of a forecasted transaction, evaluate management's determination of whether the forecasted transaction is probable.	_____	_____	_____
6. For entities with significant derivative transactions, perform the following steps:			
a. Read loan agreements, lease agreements, insurance contracts and other relevant contracts to identify embedded derivatives. Determine whether the embedded derivatives should be accounted for separately from the host contract in accordance with FASB Statement No. 133.	_____	_____	_____
b. Confirm with counter parties or executing brokers the outstanding transactions as of the balance sheet date. Consider also confirming with counter parties or executing brokers the derivatives activity during the year. Scan derivatives activity and compare it with the description of the entity's use of derivatives provided by the client.	_____	_____	_____
c. Compare the terms of individual transactions with contracts or trade tickets.	_____	_____	_____

J. Management Representations

1. Obtain written representations from management confirming aspects of management's intent and ability that affect assertions about derivatives and securities, such as its intent and ability to hold a debt security until its maturity or to enter into a forecasted transaction for which hedge accounting is applied.	_____	_____	_____
2. Consider obtaining written representations from management confirming other aspects of derivatives and securities transactions that affect assertions about them.	_____	_____	_____
3. Obtain written representations from management regarding the reasonableness of significant assumptions, including whether they appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity where relevant to the use of fair value measurements or disclosures.	_____	_____	_____

K. Service Organization Involvement

1. If a service organization provides services that are part of a client's information system, consider how the provision of those services affects the nature, timing, and extent of substantive procedures.	_____	_____	_____
2. If necessary, inspect supporting documentation, such as derivative contracts and securities purchases and sales advices, located at the service organization's facilities. (This inspection can be performed by either the auditor of the client's financial statements, an auditor working under the direction of that auditor, or an auditor engaged by the service organization.)	_____	_____	_____

	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
L. Accounting by a Transferor and Transferee for All Transfers of Financial Assets			
1. Determine that the proceeds received from the transfer of financial assets have been recognized as a sale, if all of the following conditions are met:			
a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.	_____	_____	_____
b. Each transferee (or, if the transferee is a qualifying special purpose entity (QSPE), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.	_____	_____	_____
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 the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.	_____	_____	_____
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.	_____	_____	_____

	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
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. 140, paragraph 17).	_____	_____	_____

M. Additional Procedures (if any)

N. Section Completion

1. Based on the results of the audit procedures performed, reassess the risk of material misstatement due to error and due to fraud, and determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for investments.	_____	_____	_____
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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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<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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V. Trade Accounts and Notes Receivable

Financial Statement Assertions:

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

Objectives:

- A. Existence of accounts receivable—To determine that the receivables exist, are authentic obligations owed to the entity, contain no significant amounts that should be written off, and that allowances for doubtful accounts are adequate and not excessive. (Assertions 1, 3, and 4)
- B. Proper disclosure—To determine that proper disclosure is made of any pledged, discounted or assigned receivables. (Assertions 3 and 5)
- C. Revenue recognition—To determine that interest on accounts and notes receivable has been properly recorded. (Assertions 2, 3, and 4)
- D. GAAP conformity—To determine that presentation and disclosure of receivables is in conformity with generally accepted accounting principles consistently applied. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Preliminary Procedures

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:
 - a. Preliminary analytical review

[The next page is 5447.]

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
b. Internal control documentation, control risk assessment, and control test results	_____	_____	_____
c. Assessment of risk of material misstatement	_____	_____	_____
d. Other planning documents and risk assessments	_____	_____	_____
2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<p>Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.</p>			
[A] B. Substantive Analytical Procedures			
[B] [C] [D]			
1. Compare receivable account balances with expected amounts and investigate any significant deviations from the expected amounts.	_____	_____	_____
2. Analyze the relationship of receivables and sales (day's sales in accounts receivable) and compare with relationships for the preceding period(s) (adjusted for expected changes). 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 expected amounts. Investigate any significant deviations from the expected amounts.	_____	_____	_____
5. Compute the following ratios and compare with the 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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
C. Detailed Tests				
[A]	1. Review activity in the general ledger control accounts for trade accounts receivable for the period being audited and:			
	<ul style="list-style-type: none"> a. Note and investigate any significant entries which appear unusual in amount or source. b. Compare the opening balance for the period with the final closing balances per the working papers and reports for the preceding period. 	_____	_____	_____
[A]	2. Obtain or prepare an aged trial balance of trade receivables as of the date selected for confirmation procedures. (Note: In some situations, it may not be practicable to obtain an aged trial balance until after the mailing of confirmation requests, 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:			
	<ul style="list-style-type: none"> a. Test the clerical accuracy of the trial balance. b. Reconcile the total per the aged trial balance to the general ledger control account and, if as of the balance-sheet date, to the lead schedule or working trial balance. 	_____	_____	_____
Note: When the aged trial balance and the general ledger do not agree, a monthly accounts receivable reconciliation between the two reports is an essential internal control feature.				
[A]	<ul style="list-style-type: none"> 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. 	_____	_____	_____
	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:			
	<ul style="list-style-type: none"> a. Positive requests on individually significant accounts with balances in excess of \$ ____. b. Positive requests on accounts from the sampling population as follows: 	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
Note: Due to risk assessment and planning decisions, confirmation of receivables may not be part of the audit approach. If so, complete alternative procedures as described in this program.			
c. Trace individual confirmation requests as to balances and addresses to the subsidiary accounts receivable records. Send confirmations (using envelopes with the auditor's return address) and prepare confirmation statistics.	_____	_____	_____
d. If client requests that any accounts be excluded from the confirmation process, obtain explanations and determine if such a restriction will have a significant affect on your ability to meet the audit objectives. (Consider reviewing such records as correspondence files to substantiate the explanation.) Perform appropriate alternative procedures with respect to the amounts.	_____	_____	_____
e. Trace confirmation replies to the trial balance and investigate and reconcile replies with differences.	_____	_____	_____
Note: The auditor may prepare a control of exceptions such as copies of replies or a list and arrange for the client's staff to investigate the differences and accumulate supporting documentation for the auditor's review. Be alert to explanations that may be evidence of overall conditions affecting the financial statements. Follow up on such conditions.			
f. Obtain new addresses for all confirmations returned by the post office and remail.	_____	_____	_____
g. Send second requests for all unanswered positive confirmation requests. Consider sending third requests by registered or certified mail, and performing alternative auditing procedures.	_____	_____	_____
h. Perform alternative auditing procedures for unanswered positive confirmation requests.	_____	_____	_____

Practice Tip

Be alert to large credits claimed by customers (especially close to the balance-sheet date). These credits may represent goods which were never shipped.

[A]	4. For positive confirmation requests to which no reply was received, accounts which declined to provide confirmation information and accounts which the client requested not be confirmed:			
	a. Test balances subsequently paid to remittance advices which identify the specific invoices paid.	_____	_____	_____
	b. For balances on which no payment has yet been received, examine customer's purchase orders, related invoices and shipping documents.	_____	_____	_____
	c. Establish the existence of the customer by reference to such sources as Dun and Bradstreet Reference Book.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
[A]	5. If accounts receivable were confirmed as of a date other than the balance-sheet date, obtain an analysis of transactions between the confirmation and balance-sheet dates, trace amounts to books of original entry, and review the analysis and books for significant unusual entries.	_____	_____	_____
	6. Summarize the results of the confirmation procedures.	_____	_____	_____
A B C	7. Obtain or prepare an analysis of notes receivable including the following information:			
	a. Maker	_____	_____	_____
	b. Date made/date due	_____	_____	_____
	c. Original terms of repayment	_____	_____	_____
	d. Collateral, if any	_____	_____	_____
	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> , as amended (AC F25), obtain information about the fair value of notes receivable, and perform the following:			
<hr/> Note: Disclosures about the fair value of financial instruments prescribed in FASB Statement No. 107 are optional for nonpublic entities that meet certain criteria (see FASB Statement No. 126). Determine if the client is making FASB Statement No. 107 disclosures. <hr/>				
	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 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, as amended (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/> Note: 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 I08), 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 (or, if the transferee is a qualifying special purpose entity (QSPE), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.
 - 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 the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.
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 transferred

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

E. Additional Procedures (if any)

F. Section Completion

- 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.
- 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)

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:

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
a. Preliminary analytical review	_____	_____	_____
b. Internal control documentation, control risk assessment, and control test results	_____	_____	_____
c. Assessment of risk of material misstatement	_____	_____	_____
d. Other planning documents and risk assessments	_____	_____	_____
2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____

Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.

A B B. Substantive Analytical Procedures

D	1. Compare inventory balances with expected amounts and investigate any significant deviations from the expected amounts.	_____	_____	_____
	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 (adjusted for expected changes) and investigate any significant fluctuations.	_____	_____	_____
	3. Compute gross margin and compare with expected gross margin. Investigate any significant fluctuation.	_____	_____	_____
	4. Compute gross margin by product line or division and compare with expected gross margins. Investigate any significant fluctuations.	_____	_____	_____
	5. Compute inventory turnover and compare with expected turnover. Investigate any significant fluctuation.	_____	_____	_____
	6. Compute inventory turnover by major product or division and compare with expected turnover. Investigate any significant fluctuations.	_____	_____	_____

C. Detailed Tests—General

1. Identify the locations of the physical inventories and their relative materiality by location.	_____	_____	_____
2. Review the client's plans and instructions for taking the physical inventory and accumulating, pricing, and summarizing the results. Also review the client's plans for controlling tags and count sheets, identifying obsolete items, identifying and handling			

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
consigned 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 similar | | | |

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	tests selecting the transactions from the perpetual inventory records and/or cost accounting records and trace the transactions to receiving reports, requisitions, and shipping advices.	_____	_____	_____
	Note: This test may be coordinated with tests of controls for purchases, payables, and disbursements, and for revenues, receivables, and receipts.			
D	3. Obtain an analysis of overhead costs charged to inventories and over- and under-absorbed overhead. Review the amounts included in the overhead pool for propriety and perform the following:			
	a. Determine that overhead costs are being charged to inventory in accordance with an appropriate policy (for example, as a percent of direct labor).	_____	_____	_____
	b. Identify disposition of variances, if any, between actual overhead costs incurred and overhead costs applied to production and inventory. Determine that variances are reasonable. Determine that no excessive costs for idle plant are being charged to inventory.	_____	_____	_____
C D	4. If a job order cost system is used, obtain the job order ledger (or tabulation), select a period(s) and perform the following:			
	a. Trace total costs incurred to the voucher register (or cash disbursements journal), the payroll distribution, and support for overhead applied.	_____	_____	_____
	b. Test the footings of the job order ledger by refooting the detail for selected subtotals and refooting the subtotals.	_____	_____	_____
	c. Select ____ job orders for jobs in process and completed jobs and perform the following:			
	(1) Examine authorization for the job order.	_____	_____	_____
	(2) Trace materials used on a test basis at various times since inception of the job order to such supporting details as requisitions, purchase orders, receiving reports, and processed invoices. (Consider coordination with tests of controls for purchases.)	_____	_____	_____
	(3) Trace direct labor costs to account distributions of the payroll registers and on a test basis to individual time reports or time cards. (Consider coordination with tests of controls for payroll.)	_____	_____	_____
	(4) Trace application of overhead costs to analyses used to accumulate overhead costs; test computations and review for reasonableness.	_____	_____	_____
	(5) Identify the status of the job (work in process, finished goods, or goods shipped) and trace through necessary			

<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:			
	a. Trace quantities and dollar amounts for units received for selected departments to the quantities and dollar amount transferred out per the preceding department in the sequence of production.	_____	_____	_____
	b. For each selected department, review the computations of total and unit costs for production transferred to the next department; on a test basis recompute unit costs and ascertain that costs for units lost in process are properly reallocated to surviving units.	_____	_____	_____
	c. Trace material costs charged to the selected departments to appropriate journals and on a test basis to individual requisitions.	_____	_____	_____
	d. Trace labor costs incurred to account distribution analyses of the payroll registers.	_____	_____	_____
	e. Review the allocation of overhead.	_____	_____	_____
	E. Observation of the Physical Inventory			
	1. Tour the premises on arrival and ascertain whether the inventory arrangement is conducive to a satisfactory count; if the arrangement appears obviously unsatisfactory, recommend rearrangement.	_____	_____	_____
A	2. Ascertain that items on hand which are not the property of the client are clearly identified, segregated, and excluded from the count. Note such references as descriptions, quantities, serial numbers, and shipping advice numbers so that in subsequent tests of inventory summarization the auditor may determine whether the items were excluded from the physical count.	_____	_____	_____
[A]	3. Visit the shipping and receiving departments and record the control numbers for the last shipping advice and receiving report prepared prior to the physical count for subsequent tracing to accounting department records. Consider recording a few additional shipping advice and receiving report numbers for subsequent tracing.	_____	_____	_____
A B	4. Ascertain that receiving and shipping departments are informed that receipts after and shipments before the inventory cut-off are to be excluded from the count. Ascertain that receiving reports for items not included in the count are prominently marked "after inventory."	_____	_____	_____

<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.	_____	_____	_____
F. Summarization—Physical Quantities				
A B C	1. Relate and trace information, noted during observations of the physical, about control number for count tickets or count sheets used, to the client's summarization of the physical for reasonable assurance that only tickets or sheets used for the physical are included in the summarization of quantities. (Summarization of quantities may consist of the quantities per the final priced inventory or an intermediate tabulation of count tickets. In some instances the original count sheets may provide for entry of prices, extensions, and summarization of dollar amounts.)	_____	_____	_____
B C	2. Trace test counts noted during the physical to the client's summarization of quantities.	_____	_____	_____
A	3. Trace quantities confirmed by third parties to the summarization of quantities.	_____	_____	_____
B C	4. Depending on the extent of the work in step 2 above and on internal control over inventory summarization, select quantities for particular items from the summarization and trace them to the count tickets or count sheets; select quantities for particular items from the count tickets or sheets and trace them to the summarization of quantities.	_____	_____	_____
A B C	5. If the client uses perpetual inventory records and the perpetuals are to be used to determine the year-end balance, trace items on a test basis to and from the physical inventory summaries; ascertain that the perpetuals were adjusted to the physical.	_____	_____	_____
B C	6. Trace notes made at the observation for slow moving, obsolete, and/or damaged items to the client's summarization of quantities and determine if they are clearly identified as such.	_____	_____	_____
B C	7. Test the cut-off information noted at the observation of the physical inventory as follows:			
	a. Select the last few shipping advices used before the count to the sales register; determine that the shipments were recorded as sales and charges to cost of sales as the dates shipped.	_____	_____	_____

<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>Note: Cost accounting records will differ depending upon the cost accounting system (e.g., process cost system, job order system, etc.). For the finished good item or work-in-process item selected for testing, cost accounting records should be obtained which present the various costs associated with the item selected.</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?)	_____	_____	_____
	H. Lower of Cost or Market Considerations			
B D	1. Determine whether adequate allowances have been recorded for obsolete and slow-moving inventory.	_____	_____	_____
C	2. On a test basis select items of raw materials and purchased finished goods inventory including some items with relatively significant carrying amounts (because of high unit costs or large quantities on hand) and:			
	a. Compare the inventory unit prices with prices per recent (prior to year end) vendors' invoices, vendor quotations, vendor price lists, and published market quotations.	_____	_____	_____
	b. Review purchase records and production requisitions for indications of whether items may be on hand in excess quantities, slow moving, or obsolete.	_____	_____	_____
[A] [B] C	3. On a test basis select items or classifications of finished goods and work-in-process inventories including some items with relatively significant carrying amounts (because of high unit costs or large quantities on hand) and:			
	a. Review and note current selling prices and quantities sold for the items or classifications by reference to recent sales			

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	invoices, 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.	_____	_____	_____
I. Other				
[A]	1. If the physical count was not taken as of the balance-sheet date, analyze and reconcile the balance per the physically counted inventory to inventory per the balance sheet:			
	a. Review and analyze the general ledger control accounts for inventory from the date counted to the balance-sheet date; trace additions to such sources as the purchase journal or voucher register, the cost accounting records, and charges to cost of sales.	_____	_____	_____
	b. Compare the current activity between the count date and balance-sheet date to activity of the equivalent period in the preceding year. Investigate unusual fluctuations.	_____	_____	_____
E	2. Determine whether any inventory is pledged as collateral or subject to any liens; coordinate with work on debt payable.	_____	_____	_____
D	3. Inspect open purchase order file at the balance-sheet date for significant commitments that should be considered for disclosure.	_____	_____	_____

<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)

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.

.080

Obj.Done
ByDateW/P
Ref.

VII. Property, Plant, and Equipment, and Related Depreciation

Financial Statement Assertions:

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

Objectives:

- A. Property exists—To determine that the property exists and is owned by the entity. (Assertion 1)
- B. Additions appropriate—To determine that additions to property are authentic, recorded at cost, and properly distinguished from maintenance and repairs expense. (Assertions 1, 2, and 3)
- C. Retirements recorded—To determine that retirements of property together with the proceeds from salvage and related cost to remove are properly recognized. (Assertions 1, 2, and 4)
- D. Depreciation appropriate—To determine that a proper amount of depreciation expense is allocated to the period based on the asset cost, estimated life and salvage, and use of acceptable methods consistently applied, and adequately presented in the financial statements. (Assertions 4 and 5)
- E. Recoverable value—To determine that the net carrying value as presented in the financial statements is expected to be recoverable through the ordinary course of business. (Assertion 4)
- F. Encumbrances identified—To determine that any encumbrances and liens are identified and adequately disclosed in the financial statements. (Assertion 5)
- G. Proper classification—To determine that significant amounts of idle property, plant, and equipment are properly stated, classified and described. (Assertion 5)
- H. Proper disclosure—To determine that significant amounts of fully depreciated assets are considered for disclosure. (Assertion 5)

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<p>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.</p>				
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, control risk assessment, and control test results	_____	_____	_____
	c. Assessment of risk of material misstatement	_____	_____	_____
	d. Other planning documents and risk assessments	_____	_____	_____
	2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<p>Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.</p>				
B. Substantive Analytical Procedures				
A B C D E	1. Compare balances in fixed assets, capitalized leased assets, accumulated depreciation, accumulated amortization, depreciation, repairs and maintenance, rents, supplies, and similar expense accounts with expected amounts. Investigate significant deviations from expected amounts.	_____	_____	_____
[A] [B] [C] [D] [E]	2. Compute the following ratios to help conclude upon the reasonableness of fixed asset balances. Investigate any unusual ratio results.	_____	_____	_____
	a. Fixed assets divided by total assets (indication of nonearning asset trend).	_____	_____	_____
	b. Fixed assets divided by equity (indication of funding source for fixed assets).	_____	_____	_____
C. Detailed Tests				
	1. Obtain (or update) an understanding of the client's policies concerning capitalization of assets and related depreciation methods and depreciable lives.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	2. Consider a tour of the client's facilities for new staff assigned to the engagement, or for the entire audit team if significant changes have occurred.	_____	_____	_____
	3. Consider the extent to which it may be practicable to perform substantive tests prior to the balance-sheet date.	_____	_____	_____
[A] [B] [C] [D]	4. Obtain or prepare the following schedules:			
	a. Summary schedule of property, plant and equipment, and related depreciation (by major asset classification) including the following:			
	(1) Beginning and ending asset balances at cost.	_____	_____	_____
	(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. 144 (AC I08), if any events or changes in circumstances have occurred indicating that the carrying amount of a long-lived asset may not be recoverable:			
	a. Determine if an impairment loss should be recognized. [An impairment loss should be recognized if the carrying amount of a long-lived asset is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset.]	_____	_____	_____
	(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.	_____	_____	_____
D. Leases				
A E	1. Review the permanent file to determine whether updated copies of lease agreements and other data of continuing application are included and that changes made during the year are appropriately noted.	_____	_____	_____
A B D F H	2. Examine new lease agreements and significant amendments to existing lease agreements to determine whether they are accounted for in accordance with the appropriate accounting standards (properly capitalized, appropriate depreciation, etc.), determine whether they are in accordance with established policies and procedures and document the conclusions in the permanent file.	_____	_____	_____
A F	3. Consider the advisability of obtaining from the lessor confirmation of compliance with restrictive covenants and other pertinent details of significant lease agreements.	_____	_____	_____

Practice Tip

Items to be considered for leases:

- Facilities.
- Authorization and approval of terms.
- Parties.
- Location and description of premises.
- Period covered.
- Rentals.
- Contingent payments and escalator clauses.
- Payment of ownership expenses.
- Restrictions.
- Options and renewal provisions.
- Methods and terms of cancellation.
- Subleases.
- Nature and amount of related guarantees made or obligations assumed.
- Other contractual arrangements which have the economic characteristics of a lease.
- Investment tax credit.
- Criteria for lease capitalization as set forth in appropriate accounting standards.

<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)

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
F. Section Completion			
1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for property, plant, and equipment, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for property, plant, and equipment.	_____	_____	_____
2. The objectives of this audit program have been met.	_____	_____	_____
This audit program section has been completed in accordance with firm policy.			
Done by _____	_____	_____	_____
Reviewed by _____	_____	_____	_____

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

.090

Obj.Done
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)

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.

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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, control risk assessment, and control test results	_____	_____	_____
c. Assessment of risk of material misstatement	_____	_____	_____
d. Other planning documents and risk assessments	_____	_____	_____
2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.			
B. Substantive Analytical Procedures			
A B C D 1. Compare balances in prepaid expense, deferred charges, intangibles, other assets, and accumulated amortization accounts to the expected amounts. Investigate any significant deviations from the expected amounts.	_____	_____	_____
C. Detailed Tests			
A B C E 1. Obtain or prepare an analysis for each significant classification of prepaid expenses, deferred charges, other assets or intangibles. The analysis should include adequate description of significant components and the following:			
a. Balance at the beginning of the year (or period).	_____	_____	_____
b. Additions at cost.	_____	_____	_____
c. Deductions charged to expense, and to other accounts.	_____	_____	_____
d. Balance at the end of the year (or period).	_____	_____	_____
Practice Tip			
Ordinarily, extensive detailed schedules showing computations of prepaid balances or analyses of transactions for the period are not necessary, particularly in cases where the balances are not significant. A brief summary of limited reviews and comparisons of balances with prior period amounts or tests of the client's detailed records may be satisfactory.			
2. Foot analysis and trace totals to general ledger; trace opening balance to the audit working papers for the preceding year (or period).	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A B [C] D E	3. Examine supporting documents for material charges during the year.	_____	_____	_____
[A] C [D]	4. Review and recompute amortization; determine that the amortization period and method is reasonable.	_____	_____	_____
A C [D]	5. Determine that the carrying amount of the item does not exceed amounts properly allocable to future periods.	_____	_____	_____
C	6. Trace amounts amortized during the period to the related general ledger expense accounts.	_____	_____	_____
A	7. Confirm significant deposits and assets held by others.	_____	_____	_____
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			

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	tax and the payment due dates result in prepayment or an accrual as of the balance-sheet date. Trace charges to expense to the proper expense account.	_____	_____	_____
A D	10. Obtain a list of the detail of all suspense accounts and follow-up on the clearance of all items. (Note: suspense accounts should clear in one day). Investigate any large or unusual uncleared items.	_____	_____	_____
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. Determine that acquired intangible assets are initially recognized and measured based on its fair value.	_____	_____	_____
	d. Determine that the costs of internally developing, maintaining, or restoring intangible assets that are not specifically identifiable, that have indeterminate lives, or that are inherent in a continuing business and related to an entity as a whole are expensed when incurred.	_____	_____	_____
	e. Determine that intangible assets with finite useful lives are amortized and intangible assets with indefinite useful lives are not amortized.	_____	_____	_____
	f. Ascertain whether amortization has been properly computed in conformity with FASB Statement No. 142, and trace charges to related expense accounts.	_____	_____	_____
	g. If events or changes in circumstances indicate that the carrying amount of an intangible asset that is subject to amortization may not be recoverable, determine that the intangible asset has been tested for recoverability.	_____	_____	_____
	h. For intangible assets not subject to amortization, determine that the asset is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired.	_____	_____	_____
	i. Determine that any impairment losses are properly calculated (excess of carrying amount over fair value of the asset).	_____	_____	_____
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 whether deferred advertising costs are properly accounted for in accordance with SOP 93-7 and Practice Bulletin No. 13.	_____	_____	_____
E	16. Determine any required disclosures.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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D. Additional Procedures (if any)

E. Section Completion

1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for prepaid expenses, deferred charges, intangibles and other assets, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for those accounts.

2. The objectives of this audit program have been met.

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

Done by

Reviewed by

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

.100

Obj.Done
ByDateW/P
Ref.**IX. Accounts Payable****Financial Statement Assertions:**

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

Objectives:

- A. Payables exist—To determine that accounts payable represent authorized current obligations. (Assertions 1 and 2)
- B. Proper classification—To determine that amounts included in accounts payable are properly classified. (Assertion 5)
- C. Obligations complete—To determine that accounts payable include all significant current obligations. (Assertions 2, 3, and 4)
- D. Proper disclosure—To determine that adequate disclosure has been made of any pledged assets. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e. [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:**A. Preliminary Procedures**

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:
 - a. Preliminary analytical review
 - b. Internal control documentation, control risk assessment, and control test results
 - c. Assessment of risk of material misstatement
 - d. Other planning documents and risk assessments

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

[The next page is 5481.]

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<p>Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.</p>			
B. Substantive Analytical Procedures			
A B C 1. Compare balances in trade accounts payable and purchases with the expected amounts. Investigate any significant deviations from the expected amounts.	_____	_____	_____
C. Detailed Tests			
1. Were the following items considered:			
a. Whether to request positive confirmation from vendors and, if so, when and to what extent.	_____	_____	_____
<p>Note: Some auditors send confirmations to major vendors to obtain independent outside evidence that all liabilities have been recorded. Other auditors believe that evidential matter can be obtained more efficiently through other procedures.</p>			
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.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
e. Ascertain by review of minutes, agreements and by inquiry whether any assets are pledged to collateralize payables.	_____	_____	_____
f. Identify intercompany accounts and:			
(1) Arrange to have balances traced to corresponding receivables in the affiliate's books if affiliate is being currently audited by the firm.	_____	_____	_____
(2) Obtain confirmation from the affiliate.	_____	_____	_____
(3) Investigate and reconcile differences.	_____	_____	_____
A B C [D] 3. Consider confirmation procedures such as the following:			
a. Obtain and review a list of major vendors, or identify major vendors by reviewing voucher registers or subsidiary accounts payable records.	_____	_____	_____
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A B C	11. Liabilities for payroll taxes withheld:			
	a. Trace liabilities to payments made subsequent to the balance-sheet date; examine the payroll tax deposit receipts.	_____	_____	_____
	b. Compare liability to accrued payroll taxes for reasonableness.	_____	_____	_____
	c. Trace liabilities to summaries of the applicable payroll registers.	_____	_____	_____
A B C	12. Determine that credit memos received _____ days after the balance-sheet date have been recorded in the proper period.	_____	_____	_____
B C D	13. Identify any payables due after one year and consider the imputation of interest.	_____	_____	_____
D	14. Consider the need for any disclosures.	_____	_____	_____

D. Additional Procedures (if any)

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 accounts payable, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for accounts payable.

- The objectives of this audit program have been met.

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

Done by _____

Reviewed by _____

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

.110

Obj.Done
ByDateW/P
Ref.**X. Accrued Liabilities Other Than Income Taxes and Deferred Credits****Financial Statement Assertions:**

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

Objectives:

- A. Liabilities complete—To determine that expense accounts include costs and expenses applicable to the period. (Assertions 1, 2, and 5)
- B. GAAP conformity—To determine that all contingencies and estimated future expenses that should be accrued in the period have been accrued, classified, and described in accordance with generally accepted accounting principles consistently applied. (Assertion 1, 2, 3, 4, and 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e. [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:**A. Preliminary Procedures**

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:
 - a. Preliminary analytical review _____
 - b. Internal control documentation, control risk assessment, and control test results _____
 - c. Assessment of risk of material misstatement _____
 - 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, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
	<p>Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.</p>			
	B. Substantive Analytical Procedures			
A B	1. Compare balances in accrued expense and other liability accounts with the expected amounts. Investigate any significant deviations from the expected amounts.	_____	_____	_____
	C. Detailed Tests			
[A]	1. Obtain or prepare analysis of accrued liability accounts and agree to the general ledger.	_____	_____	_____
A B	2. For accrued salaries, wages, vacation pay and bonus accounts:			
	a. Test the clerical accuracy of the analyses.	_____	_____	_____
	b. Determine whether the calculations have been made in accordance with related agreements and the corporate policies established by the board of directors or other appropriate executive groups.	_____	_____	_____
	c. Trace bonuses and similar accruals to the board of directors minutes or other proper authorizations.	_____	_____	_____
	d. Compare amounts to subsequent payments.	_____	_____	_____
A B	3. Test computations of accrued salaries and wages by tracing last payment date to payroll journals and estimating the accrual by reference to subsequent payrolls.	_____	_____	_____
A B	4. Review compensation agreements for possible additional liabilities.	_____	_____	_____
A B	5. Determine whether a liability should be accrued for employees' compensation for future absences.	_____	_____	_____

Practice Tip

Ordinarily, a liability is accrued when all of the following conditions are met:

- The employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered,
- The obligation relates to rights that vest or accumulate,
- Payment of the compensation is probable, and
- The amount can be reasonably estimated.

The fact that an accrual has not been made because of an inability to meet the last condition ordinarily should be disclosed.

<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. <i>(To be done by the in-charge.)</i>	_____	_____	_____
	_____	_____	_____	_____
	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, <i>where deemed necessary.</i>	_____	_____	_____
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.)	_____	_____	_____

Practice Tip

Read AICPA Statement of Position 96-1, *Environmental Remediation Liabilities* (appendix C), for guidance in applying step 10 above to environmental remediation liabilities. When auditing environmental remediation liabilities, steps 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)

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)

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

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<ul style="list-style-type: none"> b. Internal control documentation, control risk assessment, and control test results c. Assessment of risk of material misstatement d. Other planning documents and risk assessments 	_____	_____	_____
2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<p>Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.</p>			
B. Detailed Tests			
A B C [D] 1. Obtain or prepare analyses of the various current and deferred income tax liabilities and assets and related provisions showing:			
a. Balances at the beginning of the year (period).	_____	_____	_____
b. Amounts provided.	_____	_____	_____
c. Refunds received.	_____	_____	_____
d. Payments made, indicating date and nature.	_____	_____	_____
e. Balances at the end of the year (period).	_____	_____	_____
A 2. Compare opening balances to the prior year's working papers.	_____	_____	_____
A B 3. Trace payments to cash books and general ledger; examine canceled checks for evidence of timely payment.	_____	_____	_____
A B 4. Compare payments and refunds to copies of income tax returns.	_____	_____	_____
A B C 5. Ascertain latest year that income tax returns have been examined and which periods, if any, are being contested. Examine recent Revenue Agent Reports; determine that adequate consideration has been given to items challenged in the past. Also consider disclosure of the examination.	_____	_____	_____
A B C 6. Review or prepare a reconciliation of earnings (loss) per books with taxable income for the period.	_____	_____	_____
A B C 7. Review or compute the provisions for federal and other income taxes.	_____	_____	_____
D 8. Determine that the nature of any significant differences between pretax earnings and income tax expense are disclosed.	_____	_____	_____
A B C 9. Determine that the accrual and provision is adequate considering:			
a. Tax positions taken by the client that might be challenged by the taxing authorities or other tax contingencies.	_____	_____	_____

<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.	_____	_____	_____

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.

A B C D	12. If it is determined that it is more likely than not that all or part of the deferred tax asset will not be realized, evaluate the adequacy of the valuation allowance account by performing the following:			
	a. Review and test the process used by management to develop the estimate, or develop an independent expectation of the estimate, to corroborate the reasonableness of management's estimate.	_____	_____	_____
	b. Determine whether any subsequent events or transactions have occurred prior to the completion of field work that could effect the adequacy of the valuation allowance.	_____	_____	_____

Practice Tip

See FASB Statement No. 109, paragraphs 17–26 (AC I27.116–.125), for guidance on valuation allowance computation.

D	13. Review a schedule of net operating loss carryovers and unused investment tax credits for propriety.	_____	_____	_____
A B	14. Consider additional tax liabilities to any new states in which the client does business.	_____	_____	_____
A B C	15. If the auditor is to prepare the returns, ascertain that all necessary information is obtained.	_____	_____	_____
D	16. Obtain all necessary information for disclosure in the financial statements (e.g., tax benefits of operating loss carryovers, classification of deferred taxes, etc.).	_____	_____	_____
A B C D	17. Obtain tax department review of the income tax working papers.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
C. Additional Procedures (if any)			
D. Section Completion			
1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for income taxes, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for income taxes.			
2. The objectives of this audit program have been met.			
This audit program section has been completed in accordance with firm policy.			
Done by			
Reviewed by			

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

.130

Obj.Done
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)

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

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
b. Internal control documentation, control risk assessment, and control test results	_____	_____	_____
c. Assessment of risk of material misstatement	_____	_____	_____
d. Other planning documents and risk assessments	_____	_____	_____
2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<p>Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.</p>			
A B B. Substantive Analytical Procedures			
C			
1. Compare balances in notes payable, long-term debt, and the related interest expense accounts with the expected amounts. Investigate any significant deviations from the expected amounts.	_____	_____	_____
2. Compute the following ratios and compare to expected ratios. Investigate any significant deviations from the expected ratios.			
a. Long-term debt to stockholders' equity.	_____	_____	_____
b. Interest expense as a percentage of average balance of notes payable and long-term debt outstanding.	_____	_____	_____
C. Detailed Tests			
[A] [B]			
[C] [D]			
1. Obtain or prepare an analysis of notes payable, long-term debt, lines of credit, and other financing arrangements showing the following:			
a. Description:			
(1) Date of origin	_____	_____	_____
(2) Type of debt and maturity	_____	_____	_____
(3) Face amount	_____	_____	_____
(4) Interest rate	_____	_____	_____
(5) Timing and amount payments	_____	_____	_____
b. Principal:			
(1) Balance at the beginning of the year (period)	_____	_____	_____
(2) Additions	_____	_____	_____
(3) Payments	_____	_____	_____
(4) Balance at the end of the year (period)	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	c. Related Interest:			
	(1) Accrued interest at the beginning of the year (period)	_____	_____	_____
	(2) Unamortized discount or premium at the beginning of the year (period)	_____	_____	_____
	(3) Expense incurred during the year (period)	_____	_____	_____
	(4) Amount paid during the year (period)	_____	_____	_____
	(5) Accrued at the end of the year (period)	_____	_____	_____
	(6) Unamortized discount of premium at the end of the year (period)	_____	_____	_____
[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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
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:			
<hr/>				
<i>Note:</i> 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.				
<hr/>				
	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, as amended (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. | _____ | _____ | _____ |

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

E. Additional Procedures (if any)

F. Section Completion

1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for notes payable and long-term debt, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for notes payable and long-term debt.

2. The objectives of this audit program have been met.

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

Done by _____

Reviewed by _____

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.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)

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, control risk assessment, and control test results _____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	c. Assessment of risk of material misstatement	_____	_____	_____
	d. Other planning documents and risk assessments	_____	_____	_____
	2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<p>Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.</p>				
B. Substantive Analytical Procedures				
	1. Compare balances in shareholders' equity accounts with the expected amounts. Investigate any significant deviations from the expected amounts.	_____	_____	_____
C. Capital Stock and Additional Paid-In Capital—Detailed Tests				
[C]	1. For each class of stock, identify the number of authorized shares, par or stated value, privileges, and restrictions.	_____	_____	_____
[C]	2. Obtain or prepare an analysis of the activity in the accounts; trace opening balances to the balance sheet as of the close of the year (period) previously audited and trace closing balances to the general ledger.	_____	_____	_____
A B	3. Examine minutes, bylaws, and articles of incorporation for provisions relating to capital stock and support for all changes in the accounts including authorization per minutes of Board of Directors and stockholders meetings, and correspondence from legal counsel.	_____	_____	_____
A B	4. Account for all proceeds from stock issues (including stock issued under stock option and stock purchase plans):			
	a. Recompute sales price and applicable proceeds.	_____	_____	_____
	b. Determine that proceeds have been properly distributed between capital stock and additional paid-in capital.	_____	_____	_____
A B [C]	5. Verify outstanding stock by agreeing open stubs in stock certificate book to the listing or confirm with the transfer agent the total issued shares and the total shares issued in the company's name. Determine that surrendered certificates have been canceled and accounted for.	_____	_____	_____
A B [C]	6. For stock options and stock option plans, trace authorization to the minutes of the Board of Directors meetings, review the plan and the option contracts. Obtain 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> , as amended by FASB Statement No. 148, <i>Accounting for Stock-Based Compensation—Transition and Disclosure</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, as amended (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.	_____	_____	_____
D. Retained Earnings—Detailed Tests				
[B]	1. Analyze activity during the period; trace the opening balance to the balance sheet as of the end of the year (period) previously audited; trace net income and other activity to the proper general ledger accounts and cross reference to other working paper analyses.	_____	_____	_____
A B	2. Determine that dividends paid or declared have been authorized by the Board of Directors and:			
	a. Examine paid checks and supporting documents for dividends paid (selected checks to shareholders or to a dividend disbursing agent).	_____	_____	_____
	b. Recompute amounts of dividends paid and/or payable.	_____	_____	_____
B C	3. Investigate any prior period adjustments and determine if they were made in accordance with GAAP.	_____	_____	_____
A B C	4. Examine supporting documents and authorization for all other transactions in the account, considering conformity with generally accepted accounting principles.	_____	_____	_____
E. Other				
C	1. Determine and document any restrictions on equity accounts.	_____	_____	_____
C	2. For disclosure purposes, obtain information concerning the pertinent rights and privileges of the various securities outstanding. Information includes dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking-fund requirements, unusual voting rights, significant terms of contracts to issue additional shares, and redemption requirements. Determine that such information is accurate.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
C	3. Obtain an analysis of transactions affecting other comprehensive income for the period, relate the beginning and ending balances to the trial balance, and review the propriety of classifications.	_____	_____	_____

F. Additional Procedures (if any)

G. Section Completion

1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for shareholders' equity, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for shareholders' equity.	_____	_____	_____
2. The objectives of this audit program have been met.	_____	_____	_____
This audit program section has been completed in accordance with firm policy.			
Done by _____	_____	_____	_____
Reviewed by _____	_____	_____	_____

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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)

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.

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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, control risk assessment, and control test results	_____	_____	_____
c. Assessment of risk of material misstatement	_____	_____	_____
d. Other planning documents and risk assessments	_____	_____	_____
2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
<p>Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.</p>			
B. Substantive Analytical Procedures			
1. Compare current year sales and other income balances to the expected amounts. 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 amounts.	_____	_____	_____
C. Detailed Tests			
1. Obtain the sales journal and for a selected period(s):			
a. Trace totals from the sales journal to the general ledger control accounts for revenues, receivables, and such other accounts as salesmen's commissions, provisions, and allowances for product warranties, etc.	_____	_____	_____
b. Trace selected individual items from the sales journal to such other subsidiary records as the salesmen's commissions detail, and entries to charge cost.	_____	_____	_____
c. Reconcile the sales journal to the entries to charge cost of sales and credit inventory.	_____	_____	_____
d. Test the arithmetic accuracy of the footings and crossfootings of the journals.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	2. Obtain the cash receipts journal and perform the following on a test basis for a selected period(s):			
	a. Trace totals to the general ledger for both the cash account and applicable account distributions such as accounts receivable, cash sales, investment income, and additions to notes payable (re: proceeds).	_____	_____	_____
	b. Test the arithmetic accuracy of the footings and crossfootings of the cash receipts journal; reconcile total receipts to total deposits per the bank statement.	_____	_____	_____
A B C D	3. Select (using appropriate sampling techniques) _____ shipping orders prepared during the year and vouch to related sales invoices and trace into the sales journal.	_____	_____	_____
[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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	b. Select credit memos issued after year end and examine underlying documentation (for example, record of receipt of returned goods) to determine period to which credit memo is applicable and whether it was recorded in the proper period.	_____	_____	_____
	c. Inquire of the client if there are unprocessed sales or customer credit memos. Inspect supporting documents to determine whether they should have been recorded prior to year end.	_____	_____	_____
A C E	9. Ascertain that the following income accounts have been traced to the analysis working papers for examination of the related balance-sheet accounts:			
	a. Interest income (notes receivable, debt securities, capitalized leases, etc.).	_____	_____	_____
	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)

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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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 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)

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

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
b. Internal control documentation, control risk assessment, and control test results	_____	_____	_____
c. SAS No. 70 report on service center processed transactions (payroll)	_____	_____	_____
d. Assessment of risk of material misstatement	_____	_____	_____
e. Other planning documents and risk assessments	_____	_____	_____
2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____

Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.

A B C B. Substantive Analytical Procedures

D E F

1. Compare cost of sales and expense account balances to the expected amounts. Investigate any significant deviations from the expected amounts.	_____	_____	_____
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.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	3. Calculate gross profit percentages by product line (or other method as deemed appropriate). Compare percentages to the expected percentages and investigate significant deviations from the expected percentages.	_____	_____	_____
	4. Calculate individual expense categories as a percentage of total expenses. Compare to expected percentages. Investigate any significant deviations from expected percentages.	_____	_____	_____
C. Detailed Tests				
	1. Obtain the cash disbursements journal and for a selected period(s):			
	a. Trace totals from the cash disbursements journal to the general ledger control account for accounts payable, cash, and such other accounts as payroll expense, rent expense, insurance expense, interest expense, etc.	_____	_____	_____
	b. Select a sample of individual expenses from the cash disbursements journal for detailed testing. Trace selected expenses to supporting documentation, such as vendor invoices, canceled checks, or other subsidiary records. Determine that expenses are recorded in the proper amount and in the proper period.	_____	_____	_____
	c. Test the arithmetic accuracy of the footings and crossfootings of the journals.	_____	_____	_____
A B D	2. Scan source journals for the period for large or unusual transactions and determine that they are properly recorded.	_____	_____	_____
A B C F	3. Determine that the following expense accounts have been traced to the analysis working papers for examination of the related asset and liability balances:			
	a. Bad debt expense (allowance for doubtful accounts—trade receivables).	_____	_____	_____
	b. Insurance expense (prepaid insurance and accrued premiums for workmen's compensation).	_____	_____	_____
	c. Property taxes (prepaid and/or accrued property taxes).	_____	_____	_____
	d. Depreciation expense (property and equipment and accumulated depreciation).	_____	_____	_____
	e. Amortization costs (intangible assets).	_____	_____	_____
	f. Interest expense (notes payable, long-term debt, capitalized leases).	_____	_____	_____
	g. Provision for income taxes (liability for income taxes currently payable, deferred income taxes).	_____	_____	_____
	h. Loss on sale or disposition of property and equipment (property and equipment).	_____	_____	_____
	i. Other expenses, as deemed appropriate.	_____	_____	_____
	4. Determine that advertising costs are accounted for in accordance with SOP 93-7, <i>Reporting on Advertising Costs</i> .	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	5. Consider whether the classification of expenses is in conformity with generally accepted accounting principles consistently applied.	_____	_____	_____
D. Payroll				
A B F	1. Compute the following as a percentage of total revenues and compare to prior year's percentages or expected percentages. Investigate any significant deviations from the expected percentages. a. Payroll (direct and indirect labor, officers' salaries) b. Benefits c. Commissions	_____	_____	_____
A B F	2. Compute average compensation and fringes divided by number of full-time equivalents (FTEs) and compare to prior years and peer group statistics.	_____	_____	_____
A B F	3. Calculate and investigate total payroll and benefits costs divided by average assets, compare to prior year's ratio or expected ratio, and correlate results to other analytical procedures. Investigate significant or unexpected results.	_____	_____	_____
A B F	4. Compute payroll tax expense as a percentage of total wages and salaries and compare to prior year's percentage or expected percentage. Investigate significant deviations from expected percentages.	_____	_____	_____
A B F	5. Reconcile gross wages on payroll tax returns to general ledger.	_____	_____	_____
A B F	6. Review payroll tax returns to determine that they are being properly filed; and tax liabilities are paid timely.	_____	_____	_____
A B F	7. If analytical procedures are not deemed sufficient, select a sample of payroll transactions for detailed testing as follows: a. Trace selected employee to personnel records, to verify existence of employee, pay rate, legal status, etc. b. Recalculate gross and net pay for propriety. c. Trace pay amount into proper recording into subledgers and general ledger.	_____	_____	_____
E. Additional Procedures (if any)				

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
F. Section Completion			
1. Based on the initial planning conclusions, on the results of the audit procedures performed, and upon the assessed level of risk for operating and other expenses, determine whether additional procedures need to be performed to obtain sufficient evidence regarding the financial statement assertions for operating and other expenses.	_____	_____	_____
2. The objectives of this audit program have been met.	_____	_____	_____
This audit program section has been completed in accordance with firm policy.			
_____	_____	_____	_____
Done by	_____	_____	_____
_____	_____	_____	_____
Reviewed by	_____	_____	_____

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

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Obj.Done
ByDateW/P
Ref.**XVI. Contingencies, Commitments, and Litigation****Financial Statement Assertions:**

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

Objectives:

- A. Contingencies exist—Identify the existence of any contingencies arising from litigation, claims, and assessments; when the underlying cause occurred; the likelihood of an unfavorable outcome, and the amount or range of possible loss. (Assertions 1, 2, 3, and 4)
- B. Proper recording and disclosure—The financial statements include proper accruals and/or disclosure of the contingencies. (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 _____
 - 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, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.	_____	_____	_____
	Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.			
	B. Contingencies			
A B	1. If it appears the client may have engaged in any questionable or illegal acts or irregularities, obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. Procedures are to include inquiry of management at a level above those involved, if possible.	_____	_____	_____
A B	2. If management does not provide satisfactory information that there has been no illegal acts or irregularities, consult with the client's legal counsel or other specialists about the application of relevant laws and regulations. Arrangements for such consultation with client's legal counsel should be made by the client.	_____	_____	_____
A B	3. Review minutes of directors' meetings and discuss all pertinent items with management. Make excerpts and agree to applicable 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.	_____	_____	_____
<i>List of All Lawyer Letters Requested</i>		<i>Date Requested</i>	<i>Received</i>	
_____		_____	_____	
_____		_____	_____	
_____		_____	_____	
_____		_____	_____	
_____		_____	_____	
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 and Guarantees				
A B	1. Inquire of appropriate officials as to the existence and amount of commitments, and determine that such commitments are accounted for and disclosed of as appropriate. Consider 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.	_____	_____	_____
2. Determine that guarantees have been identified, accounted for, and disclosed in accordance with GAAP, including FASB Statement Nos. 5, 57, 107, and FASB Interpretation No. 45.	_____	_____	_____

D. Additional Procedures (if any)

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.

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<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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XVII. Subsequent Events

Financial Statement Assertions:

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

Objectives:

- A. Existence of subsequent event—Any events or transactions occurring after the balance-sheet date, but before issuance of the financial statements and auditor’s report (subsequent events) which require adjustment or disclosure in the financial statements. (Assertions 1, 2, 3, and 4)
- B. Proper recognition—The financial statements have been adjusted for changes in estimates resulting from evidence provided by subsequent events. (Assertions 1, 2, 3, and 4)
- C. Proper disclosure—The financial statements include adequate disclosure of evidence provided by subsequent events which should not result in adjustment of the financial statements but should be disclosed. (Assertion 5)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, i.e., [A], [B], etc., the audit procedure only secondarily accomplishes the objective.

Procedures:

A. Substantive Test Procedures

- A B C 1. Perform at or near the completion of field work the following auditing procedures with respect to the period after the balance-

<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. 85 (AU section 333), as amended.	_____	_____	_____
A B C	5. Make such additional inquiries or perform such procedures deemed necessary and appropriate to dispose of questions that arise in carrying out the foregoing procedures, inquiries, and discussions.	_____	_____	_____
C	6. Consider adjustment of year-end financial statements or disclosure of any items resulting from the above procedures.	_____	_____	_____
C	7. Consider the possible effects on financial statements and disclosures of any matters causing substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.	_____	_____	_____

B. Section Completion

1. The objectives of this audit program have been met.

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

Done by _____

Reviewed by _____

The material included in this section is presented for illustrative purposes only. The illustrative audit objectives and illustrative audit procedures are neither all-inclusive nor are they prescribed minimums. The illustrative audit procedures are numbered merely to organize the materials; those numbers are not intended to imply completeness or a prescribed sequence. The nature, extent and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the specific facts and circumstances.

.190

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)

Note: The letters preceding each of the above audit objectives serve as identification codes. These codes are presented in the objective column when the audit step accomplishes the specific objective. If the letter appears in brackets, the audit procedure only secondarily accomplishes the objective.

Procedures:**A. Preliminary Procedures**

1. Review the results of applicable sections of the following to determine the nature, timing, and extent of procedures:
 - a. Preliminary analytical review
 - b. Assessment of risk of material misstatement
 - c. Other planning documents and risk assessments
2. Based on the risk assessment made during planning, determine whether additional procedures, beyond those included in this program, are necessary. Consult all relevant planning documents when making this decision. If additional procedures are necessary, add them to this program.

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

Obj.		Done By	Date	W/P Ref.
	Note: Use the assessed levels of inherent risk and control risk to determine the nature, timing, and extent of the substantive procedures to be performed. Listed below are examples of substantive procedures that an auditor may decide to perform, based on the assessment of risk. An auditor should select which procedures below need to be performed and should add additional procedures to those listed below, as necessary.			
	B. Substantive Test Procedures			
A B C	1. Make inquiries of management about related parties, obtain related-party confirmation, if applicable, and inquire about any recorded or unrecorded transactions during the year.	_____	_____	_____
A	2. Obtain names of stockholders and directors for evidence of related-party transactions.	_____	_____	_____
A	3. Review last year's working papers for evidence of related-party transactions.	_____	_____	_____
A	4. Ask predecessor auditors about related parties.	_____	_____	_____
A B C	5. Investigate transactions with major customers, suppliers, and lenders for undisclosed relationships.	_____	_____	_____
A B C	6. Review minutes of stockholders' and directors' meetings for evidence of related-party transactions.	_____	_____	_____
A B C	7. Be alert for potential related-party transactions while examining confirmations of receivables and payables, large unusual transactions and attorneys' letters.	_____	_____	_____
C	8. Obtain a list of major customers, amounts of sales during the year and amounts of receivables at year end. Agree to detail client records. Consider disclosure.	_____	_____	_____
B C	9. Examine supporting documents of significant related-party transactions to determine:			
	a. Business purpose.	_____	_____	_____
	b. Board of directors' approval.	_____	_____	_____
	c. Reasonableness and consistency of amounts to be disclosed.	_____	_____	_____
	d. Financial capabilities of related parties.	_____	_____	_____
	C. Additional Procedures (if any)			

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
D. Section Completion			
1. The objectives of this audit program have been met.	_____	_____	_____
This audit program section has been completed in accordance with firm policy.			
_____	_____	_____	_____
Done by			
_____	_____	_____	_____
Reviewed by			

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			
<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>

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: <ul style="list-style-type: none">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 com- pletely and accurately included in the financial statements.	_____	_____	_____
B. Section Completion				
	1. The objectives of this audit program have been met.	_____	_____	_____
This audit program section has been completed in accordance with firm policy.				
Done by _____		_____	_____	_____
Reviewed by _____		_____	_____	_____

[The next page is 5551.]

AAM Section 5410

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

.01 Suggested Supplemental Reference Materials

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.

- **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.

- **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 Implications of Electronic Document Management and The Information Technology Age: Evidential Matter (AICPA)**

These two Auditing Procedures Studies contain helpful and valuable guidance about the implications of electronic evidence on an audit.

- **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

Audit Documentation

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AAM Section 6100

Audit Documentation—General

.01 Audit documentation¹ is the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in the engagement. SAS No. 96, *Audit Documentation* (AU section 339), provides authoritative guidance on the functions and nature, general content, and ownership and confidentiality of audit documentation.

.02 Other SASs contain specific documentation requirements and can be found in Appendix A of SAS No. 96 (AU section 339.15). Additionally, specific documentation requirements may be included in other standards (for example, government auditing standards), laws, and regulations applicable to the engagement. Furthermore, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, paragraph 83 (AU section 316.83), includes documentation requirements regarding the auditor's consideration of fraud and SAS No. 100, *Interim Financial Information*, paragraph 51 (AU section 722.51), includes documentation requirements the auditor should be aware of.

.03 The auditor should prepare and maintain audit documentation, the form and content of which should be designed to meet the circumstances of the engagement. Audit documentation serves mainly to provide the principal support for the auditor's report, including the representation regarding observation of the standards of fieldwork, which is implicit in the reference in the report to generally accepted auditing standards, and aid the auditor in the conduct and supervision of the audit.

.04 SAS No. 96 (AU section 339) provides authoritative guidance on audit documentation. SAS No. 96 supersedes SAS No. 41, *Working Papers*, and amends the following Statements:

- SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312)
- SAS No. 56, *Analytical Procedures* (AU section 329)
- SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341)

General Discussion

.05 These sections present points of view on the organization and preparation of audit documentation.

.06 Proper planning is important in the design of specific audit documentation 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 quality, type, and content of the audit documentation are matters of the auditor's professional judgment. The individual preferences of auditors and firms 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 audit documentation. Those procedures and policies should permit the flexibility necessary to meet the needs of individual engagements.

[The next page is 6201.]

¹ Audit documentation also may be referred to as working papers.

AAM Section 6200

Basic Elements of Format

.01 Audit documentation 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 audit documentation 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 audit documentation. (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
- audit documentation reference
- footed by
- extensions checked by

.04 Some auditors prefer to identify client preparation of schedules and analysis by notations or codes, such as "PBC," for prepared by client, rather than use a detailed signature and reference block.

[The next page is 6301.]

AAM Section 6300

Content of Audit Documentation

.01 The content of audit documentation varies with the circumstances and needs of the auditors on individual engagements. Some firms, however, include various general and specific instructions on audit documentation content in their policies concerning the working papers.

.02 Audit documentation should be sufficient to show that standards of fieldwork have been observed as follows:

- a. The work has been adequately planned and supervised.
- b. A sufficient understanding of internal control has been obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
- c. Sufficient competent evidential matter has been obtained through the auditing procedures applied to afford a reasonable basis for an opinion.

.03 Examples of audit documentation are audit programs, analyses, memoranda, letters of confirmation and representation, abstracts or copies of entity documents, and schedules or commentaries prepared or obtained by the auditor. Audit documentation may be in paper form, electronic form or other media.

.04 The audit documentation should be sufficient to (a) enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent and results of auditing procedures performed, and the evidence obtained; (b) indicate the engagement team member(s) who performed and reviewed the work; and (c) show that the accounting records agree or reconcile with the financial statements or other information being reported on.

.05 In determining the nature and extent of the documentation for a particular audit area or auditing procedure, the auditor should consider the following factors:

- Risk of material misstatement associated with the assertion, or account or class of transactions
- Extent of judgment involved in performing the work and evaluating the results.
- Nature of the auditing procedure
- Significance of the evidence obtained to the assertion being tested
- Nature and extent of exceptions identified
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed

General Considerations

.06 The following are some general considerations on audit documentation content that may be helpful.

- Audit documentation 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 audit documentation 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 audit documentation indicated by parentheses instead of red figures to preserve their identity if the papers are photocopied or microfilmed.

Specific Considerations

.07 Audit documentation should include abstracts or copies of significant contracts or agreements that were examined to evaluate the account for significant transactions. Additionally, audit documentation of tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation should include an identification of the items tested.

.08 Furthermore, the auditor should document audit findings or issues that in his or her judgment are significant, actions taken to address them (including additional evidence obtained), and the basis for the final conclusions reached. Significant audit findings or issues include the following:

- Matters that are both (a) significant and (b) involve issues regarding the appropriate selection, application and consistency of accounting principles with regard to the financial statements, including related disclosures. These matters often relate to accounting for complex or unusual transactions. In addition, these matters may refer to estimates and uncertainties, and if applicable the related management assumptions.
- Results of auditing procedures that indicate that the financial statements or disclosures could be materially misstated or auditing procedures need to be significantly modified.
- Circumstances that cause significant difficulty in applying auditing procedures that the auditor considered necessary.
- Other findings that could result in modification of the auditor's report.

.09 SAS No. 96 (AU section 339) amends SAS No. 59, *The Auditors' Consideration of an Entity's Ability to Continue as a Going Concern* (AU section 341). The amendment adds a requirement for the auditor to document:

- The conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern.

- The work performed in connection with the auditors evaluation of management's plans
- The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated
- The consideration and effect of that conclusion on the financial statements, disclosures, and the audit report.

Timesaving Considerations

.10 There are a number of ways to save time and avoid unnecessary detail in audit documentation 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 audit documentation on the scope of audit procedures. (However, some believe that such comments are still necessary when a detailed program is used; this is a matter of individual firm judgment.)
- Analyze asset (or liability) accounts and their related expense or income accounts on the same working paper. Examples include property, plant, and equipment, accumulated depreciation and related depreciation expense; notes receivable, accrued 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.
- Use symbols (tick marks) whenever possible, especially when the same symbol applies to several working papers.

Symbols (Tick Marks)

.11 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 audit documentation.
- 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.

.12 Applying these basic concepts is not that simple. Various auditors have conflicting notions about symbols. For example, some believe a set of standardized symbols can expedite preparation and review. Others believe that a set of standardized symbols is impractical because it lacks flexibility. Because it is generally agreed that symbols are an effective timesaver, it is desirable for firms to establish and communicate a policy on their use to maximize their potential effectiveness.

.13 Commonly used symbols, as noted, should be simple and distinctive, not elaborate hieroglyphics. The most common are variations on a simple checkmark—for example, a checkmark with a slash, a checkmark with a circle at the end, a double checkmark, and any one of these within a circle. This abbreviated listing alone provides eight distinctive tick marks. Symbols may also include circled letters or numbers.

[The next page is 6401.]

AAM Section 6400

Organization and Filing (Indexing)

.01 Some auditors organize their audit documentation during the course of an engagement into general categories such as the following:

- Planning and administration.
- Internal control understanding and assessment of control risk.
- Substantive test audit documentation arranged in order of the balance sheet and income statement classifications.
- Trial balances, consolidating working papers, journal entries (adjustments, reclassifications, eliminations for consolidation), and potential entries.
- Draft reports, financial statements, and notes.
- Programs, checklists, and questionnaires (some keep these as separate units, 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 audit documentation during the performance of field work.
- Constant arrangement of audit documentation in logical order to aid in review.
- Less time required in assembling and binding them into indexed files.
- Quicker access to specific audit documentation after it is filed.

.03 Predetermined indexing involves establishing a standard code for each section of the audit documentation, using letters and numbers, or numbers only. 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 audit documentation needs or specialized industry requirements and it requires care to avoid undue complexity. Excessively complex references may obstruct rather than ease audit documentation preparation, cross-referencing and filing. Accordingly, it is helpful to develop an organizational plan adaptable to each section of the audit documentation. For example, some accountants classify working papers as lead schedules, primary detail, and secondary detail 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 audit documentation binders or files when the work is completed. Some firms have their uniform indexing systems printed directly on their file or binder covers.

.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 audit documentation.	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 audit documentation file, index 9300, for example, may be assigned to internal control. Accordingly, flowcharts and related questionnaires would be assigned index numbers in that series.

Current and Permanent Files

.10 Audit documentation files are generally classified as current files and permanent (continuing) files. Current files contain information that is pertinent to a single engagement. Permanent files include information relevant to several recurring engagements. Some firms have their binder or file covers preprinted as current or permanent accompanied by pertinent portions of their uniform audit documentation indexes.

.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 audit documentation should be classified as current with certain materials designated as matters of continuing interest to be carried forward each year until they become outdated. Under this approach, a firm may preprint its complete index on one type of file or binder cover and provide space to indicate whether specific contents are continuing or carryforward in nature.

.13 The permanent files should be reviewed and updated, as needed, annually. Examples of documents that may be found in permanent files are listed in AAM section 6400.15(p).

Practice Tip

The audit documentation files should contain copies of final executed documents. Any drafts or unsigned versions of documents should be replaced with final versions.

Audit Documentation 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 Audit documentation 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 audit documentation that should be retained permanently include auditor's reports, reports filed with the SEC, tax returns for current clients, and audit documentation 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 audit documentation 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*.

Ownership and Confidentiality of Audit Documentation

.17 Audit documentation is the property of the auditor, and some states recognize this right of ownership in their statutes.

.18 The auditor has an ethical and in some situations a legal obligation to maintain the confidentiality of client information. Because audit documentation contains confidential client information, the auditor should adopt reasonable procedures to maintain the confidentiality of that information.

.19 The auditor should adopt reasonable procedures to prevent unauthorized access to the audit documentation.

.20 Certain audit documentation may sometimes serve as a useful reference source for the client, but it should not be regarded as part of, or a substitute for, the client's accounting records.

Index Topics

.21 The following is a list of topics to consider in developing a standard index for audit documentation. 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 audit documentation)
- 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 audit documentation segments in the current file.
2. Certain classifications may lend themselves to carry-forward audit documentation. Examples include allowances for doubtful accounts, brief summaries of confirmation response statistics, accumulated depreciation and amortization, deferred income taxes and open tax positions, long-term debt, and capital accounts.
3. Internal control questionnaires may be filed as separate binders or as part of current of permanent files.
4. Some firms and practitioners keep tax return preparation working papers in files that are completely separate from other types of engagement working papers.
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 audit documentation (for example: accounts receivable, accounts payable, and inventory).

[The next page is 7001.]

AAM Section 7000

Correspondence, Confirmations & Representations

These samples are presented for illustrative purposes only. They are intended as mere conveniences for users of this Manual who may want points of departure when designing their own formats to meet their individual needs. These illustrations are neither all inclusive nor are they prescribed minimums. Auditors and accountants are to rely on professional standards and their individual professional judgment in determining what may be needed in the circumstances.

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AAM Section 7100

Control of Confirmations and Correspondence

.01 Generally, clients prepare correspondence and confirmation requests on their own letterhead and submit to the auditor the signed originals and copies. The auditor may obtain one or more copies to serve as file copies for the current audit documentation, second requests and manuscript copies for the next engagement.

.02 There are two types of confirmation requests: the positive form and the negative form. Some positive forms request the respondent to indicate whether he or she agrees with the information stated on the request. Other positive forms, referred to as blank forms, do not state the amount (or other information) on the confirmation request, but request the recipient to fill in the balance or furnish other information.

.03 The negative form requests the recipient to respond only if he or she disagrees with the information stated on the request. Negative confirmation requests may be used to reduce audit risk to an acceptable level when (a) the combined assessed level of inherent and control risk is low, (b) a large number of small balances is involved, and (c) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.

.04 The confirmation requests should be reviewed to the extent the auditor considers necessary. For example, the auditor may perform the following for accounts receivable confirmation requests before they are mailed:

- Compare the names and addresses to the client's records.
- Compare balances per confirmation requests to the subsidiary ledger.

.05 The requests would then be stuffed in envelopes and submitted to the post office under the auditor's control.

.06 The auditor controls the mailings and receipt of responses so that the confirmation process is independent of the client.

.07 Mailing envelopes have the auditor's office or post office box number as the return address so that undeliverable letters are returned to the auditor and not to the client. For mailings, the auditor may provide the envelopes or affix a label on the client's envelope that covers the client's return address and replaces it with the auditor's address.

.08 Reply envelopes addressed to the auditor are enclosed with the request letter. Reply envelopes generally have prepaid postage to encourage responses. Some auditors also use codes on the reply envelopes so that responses may be sorted by engagement before the mail is opened. This feature may be particularly useful when there are several engagements that involve voluminous mailings.

.09 If the client objects to use of the auditor's name and address, some auditors suggest that a post office box in the client's name be used, with the returns to be opened under the auditor's control for the confirmation process, and that the post office be instructed that after the box is closed subsequent mail be forwarded to the auditor.

[The next page is 7201.]

AAM Section 7200

Requests for Confirmations and Related Materials

Wording of Confirmation Request Forms

.01 Forms and correspondence used for confirmation requests should state clearly that the client is requesting that a reply be sent to the CPA. Forms and correspondence used for information requests for engagements other than audits should not refer to “an audit.” They should also use the term “accountant(s)” rather than “auditors.” Suggested wording follows:

Please send the following information to our certified public accountants (*name and address of accountants*) who are performing accounting services for the company.

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

.03 Request for Bank Cutoff Statement*[Prepared on Client's Letterhead]**[Date]*

Financial Institution Official
 First United Bank
 Anytown, USA 00000

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

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

<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 _____, 20____, regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below * Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below Please use the enclosed envelope to return the form directly to our accountants.

1. At the close of business on the date listed above, our records indicated the following deposit balance(s):

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, 20XX 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, 20XX with the following exceptions (if any):

Date: _____ Signed: _____

.06 Securities and Cash in Custodian or Trust Accounts*[Prepared on Client's Letterhead]**[Date]**[Name of Custodian or Trustee]**[Address]*

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

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)

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

FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits* (AC P16 and P40), provides reduced disclosure requirements for nonpublic companies. Part C of this letter assumes companies have elected the reduced disclosures allowed by that statement. Paragraph 8 of FASB Statement No. 132 describes the reduced disclosure requirements. For companies not electing the reduced disclosures, information required for disclosure can be obtained from Parts B and D of the letter.

[Prepared on Client's Letterhead]

[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 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.
4. Any substantive commitments for benefits that exceed the benefits defined by the written plan that are included in the calculations.
5. Determination of the value of any insurance or annuity contracts included in the assets.
6. 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.
7. 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>
---	------------------------------	------------	---------------	---

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. Expected return on assets^{*} _____
4. Other components^{*} _____
 - a. Amortization of unrecognized net loss or (gain) from earlier periods _____
 - b. Amortization of unrecognized prior service cost _____
 - c. Amortization of the remaining unrecognized net obligation or (asset) existing at the date of the initial application of FASB Statement No. 87—transition obligation or (asset) _____
 - d. Amount of loss (or gain) recognized due to a settlement or curtailment. _____
 - e. Net total of components
(a + b + c + d) \$ _____
5. Net periodic pension cost:
(1 + 2 – 3 + 4e) \$ _____

6. The above measurement of the net periodic pension cost is based on the following assumptions:

Weighted-average discount rate	_____ %
Weighted-average rate of compensation increase	_____ %
Weighted-average expected long-term rate of return on plan assets	_____ %

Please describe the basis on which the above rates were selected and whether the basis is consistent with the prior period.

Please briefly describe the other assumptions used in the above measurement.

^{*} This information (or parts thereof) is required for disclosure by companies that do not elect the reduced disclosures permitted by FASB Statement No. 132. In addition, the information may be needed for any company to determine that the accounting for the plan is in accordance with FASB Statement No. 87, *Employers' Accounting for Pensions*, and FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*.

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 for disclosure in the financial statements for the period ending _____:

- | | <i>Estimated</i> |
|---|------------------|
| 1. Projected Benefit Obligation | \$ _____ |
| 2. Fair Value of Plan Assets | _____ |
| 3. Funded Status of the Plan (2-1) | _____ |
| 4. Employer Contributions to the Plan | _____ |
| 5. Participant Contributions to the Plan | _____ |
| 6. Benefits Paid | _____ |
| 7. (Accrued) or prepaid pension cost in the company financial statements | _____ |
| 8. The amount of any intangible asset recognized in accordance with paragraph 37 of FASB Statement No. 87, as amended. | _____ |
| 9. The amount of accumulated other comprehensive income recognized in accordance with paragraph 37 of FASB Statement No. 87, as amended. | _____ |
| 10. The amount included in other comprehensive income for the period arising from a change in the minimum pension liability recognized in accordance with paragraph 37 of FASB Statement No. 87, as amended. | _____ |
| 11. The above amount of the projected benefit obligation is measured based on the following assumptions: | |
| Weighted-average discount rate | _____ % |
| Weighted-average rate of compensation increase | _____ % |
| Please provide a brief description of the other assumptions used in the measurement. | |
| 12. The calculation of the items shown in C1 to C10 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 C10. | |
| 13. Please describe any significant events noted subsequent to the current year's measurement date and as of the date of your reply to this request and the effects of those events, such as a large plant closing, which could materially affect the amounts shown in C1 to C10. | |
| 14. Please describe any significant transactions between the employer or related parties and the plan during the period, including, if applicable, the amounts and types of securities of the employer and related parties included in plan assets and the amount of future annual benefits covered by insurance contracts issued by the employer or related parties. | |

- D. Please provide an analysis for the period showing beginning amounts, additions, reductions, and ending amounts of the:
1. Projected benefit obligation,
 2. Fair value of plan assets,
 3. Unrecognized prior service cost,
 4. Unrecognized net loss (gain),
 5. Net transition obligation (asset), and
 6. Accumulated benefit obligation (ending amount only).
- E. Please provide our independent auditors with descriptions and the amounts of gains or losses from combinations, divestitures, settlements, curtailments or termination benefits during the year, such as:
1. Purchases of annuity contracts,
 2. Lump-sum cash payments to plan participants,
 3. Other irrevocable actions that relieved the company or the plan of primary responsibility for a pension obligation, and 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 Statement Nos. 87, 88, and 89 (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.

Please mail your response directly to [Audit Firm's Name and Address] in the enclosed return envelope as soon as possible, but no later than [Date].

Very truly yours,

[Client's Authorized Signature]

* This information (or parts thereof) is required for disclosure by companies that do not elect the reduced disclosures permitted by FASB Statement No. 132. In addition, the information may be needed for any company to determine that the accounting for the plan is in accordance with FASB Statement No. 87, *Employers' Accounting for Pensions*, and FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*.

.16 Pension Plan Assets Held by Trustee

[Prepared on Client's Letterhead]

[Date]

[Name of Trustee or Custodian]

[Address]

Our auditors (*name and address of auditor*) are conducting an audit of our financial statements. Accordingly, please provide our auditors directly with a listing of the assets including market values as of (*date*) for our employees' pension trust (*title and trustee's account number*).

Please also provide the auditors with the following information about our employees' pension trust for the period from (*beginning of period*) to (*end of period*) [see note below]:

1. Contributions by the Company during the above period.
2. Contributions by employees during the above period.
3. Payments to beneficiaries during the above period.
4. Any unpaid fees due for services rendered to (*balance-sheet date*).

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

Very truly yours,

[Client's Authorized Signature]

Note: A listing of the assets might not be requested if one had already been received by the client. In that case, the auditor might want the trustee to confirm the total market value per the listing.

.17 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: _____

.18 Mortgage Debt

[Prepared on Client's Letterhead]

[Date]

[Name of Creditor or Trustee]

[Address]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about our mortgage indebtedness to you as of (*date*):

1. Original amount \$ _____
2. Date of note _____
3. Unpaid principal balance \$ _____
4. Interest rate _____ %
5. Terms for payment of principal _____
6. Date to which interest has been paid _____
7. Nature of mortgage and description or address of property mortgaged _____
8. Amounts on deposit with you in escrow for:
 - a. Insurance \$ _____
 - b. Real estate taxes \$ _____
9. Amounts paid during the period (*dates from and to*) for:
 - a. Insurance \$ _____
 - b. Taxes \$ _____
10. Amounts on deposit with you for the "reserve for repairs" \$ _____
11. The nature of defaults, if any _____
12. Description of terms, e.g., prepayment penalties, demand provisions, etc. _____

A return envelope is enclosed for your reply.

Very truly yours,

[Client's Authorized Signature]

Note: Many of the items requested will vary with the circumstance of the particular mortgage or other debt involved. The above sample assumes the indenture involves an escrow arrangement for insurance and real estate taxes and a deposit account for repairs.

.19 Accounts Payable

[Prepared on Client's Letterhead]

[Date]

[Name]

[Address]

In connection with the audit of our financial statements, please confirm directly to our auditors (*name and address of auditors*), the amount of our liability to you as of (*date*). Please attach a statement of our account due. If no balance is due, please attach a statement of our account showing payments made.

Please mail your reply directly to (*name of auditors*). A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,

[Client's Authorized Signature]

Our records indicate that a balance of \$_____ was from (*name of client*) at (*date*).

Date: _____

Signature: _____

Title: _____

.20 Obligation to Lessor

[Prepared on Client's Letterhead]

[Date]

[Name of Lessor]

[Address]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements as of (*balance-sheet date*) and for the (*time period*) then ended. In connection with this audit, please provide directly to our auditors the following information as of (*balance-sheet date*) regarding the lease dated (*date lease was executed*) of (*brief identification of property under lease*) which we are leasing from you:

1. Inception and expiration dates for the lease period, from _____ to _____
2. Amount of monthly rent _____
3. Renewal options (if any):
 - a. Dates of renewal period, from _____ to _____
 - b. Amount of monthly rent for renewal _____
4. Purchase options (if any):
 - a. Amount of purchase price _____
 - b. Inception and expiration dates of option, from _____ to _____
 - c. Percent of monthly rent (if any) applicable towards purchase price _____
5. Dates and descriptions of amendments or supplementary understandings, if any, to the lease mentioned above.
6. The amount of outstanding delinquent payments, if any.
7. A statement that there are no defaults, or the nature of defaults, if any.

A return envelope is enclosed for your reply.

Very truly yours,

[Client's Authorized Signature]

Note: The content of this type of letter will vary based on the auditor's professional judgment in the circumstances. To provide additional illustrative language, the above letter is not made parallel with the illustration at AAM section 7200.23.

.21 Property Out on Lease

[Prepared on Client's Letterhead]

[Date]

[Name of Lessee]

[Address]

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements as of (*balance-sheet date*) and for the (*time period*) then ended. In connection with this audit, please confirm directly to our auditors the following information regarding the lease dated (*execution date of lease*) of (*brief identification of property under lease*) 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.

.22 Register—Capital Stock*[Prepared on Client's Letterhead]**[Date]**[Name of Registrar]**[Address]*

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of the close of business (*balance-sheet date*) about each class of our preferred and common stock:

1. Authorized number of shares _____
2. Issued number of shares _____
3. Outstanding number of shares _____

Please also indicate the amount of any unpaid registrar fees due you as of (*balance-sheet date*).

A return envelope is enclosed for your convenience.

Very truly yours,

[Client's Authorized Signature]

The above information agrees with our records at (*balance-sheet date*) with the following exceptions: _____

Signed: _____ Date: _____

[Name and Title]

Notes: (A) It may be helpful to include the registrar's account number for the client's account to receive a timely response.

(B) Some auditors prefer that the confirmation request include identification of each class of stock.

(C) The above illustration assumes the client has a separate transfer agent (see AAM section 7200.25).

.23 Transfer Agent—Capital Stock*[Prepared on Client's Letterhead]**[Date]**[Name of Transfer Agent]**[Address]*

Our auditors (*name and address of auditors*) are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of (*balance-sheet date*) about each class of our preferred and common stock:

1. Authorized number of shares _____
2. Number of shares issued and outstanding _____
3. Number of outstanding shares registered in the name of our Company _____

Please also indicate the amount of any unpaid transfer agent fees due you as of (*balance-sheet date*).

A return envelope is enclosed for your convenience.

Very truly yours,

[Authorized Signature for Client]

The above information agrees with our records at (*balance-sheet date*) with the following exceptions: _____

Signed: _____ Date: _____

[Name and Title]

Notes: (A) It may be helpful to include the transfer agent's account number for the client's account to receive a timely response.

(B) Some auditors prefer that the confirmation request include identification of each class of stock.

(C) Depending on the auditor's judgment in the circumstances the confirmation request may also include inquiries about such matters as (i) the number of shares issued to each of specifically mentioned officers and directors, (ii) specified information about shareholders owning more than a stated percent of the total outstanding shares, and (iii) amounts deposited during the year for the payment of dividends.

.24 Request for Confirmation of Money Market Fund*[Prepared on Client's Letterhead]**[Date]**[Name]**[Address]*

Our auditors, *(name and address of auditors)* are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of our money market fund account(s) as of *(date)*.

Please indicate in the space provided below the account number(s) and balance(s) of our account(s) per your records.

Please sign and date your reply and return it directly to the auditors. A stamped, self-addressed envelope is enclosed for your convenience.

Very truly yours,

[Client's Authorized Signature]

Account No.

Date

Balance

Date: _____

Signed: _____

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Dear CPA Firm:

The above information listing contingent liabilities, including oral and written guarantees, agrees with the records of this financial institution.* Although we have not conducted a comprehensive, detailed search of our records, no information about other contingent liabilities, including oral and written guarantees, came to our attention. [Note exceptions below or in an attached letter.]

[Name of Financial Institution]

By:

[Officer]

[Date]

[Title]

* If applicable, comments similar to the following may be added to the confirmation reply by the financial institution: This confirmation does not relate to arrangements, if any, with other branches or affiliates of this financial institution. Information should be sought separately from such branches or affiliates with which any such arrangements might exist.

.26 Confirmation of Compensating Balances

[Date]

Financial Institution Official*
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of *(name of customer)* as of *(balance-sheet date)* and for the *(period)* then ended, we have advised our independent auditors that as of the close of business on *(balance-sheet date)* there *(were)* *(were not)* compensating balance arrangements as described in our agreement dated *(date)*. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other compensating balance arrangements between *(name of customer)* and your financial institution comes to your attention, please include such information below. Withdrawal by *(name of customer)* of the compensating balance *(was)* *(was not)* legally restricted at *(date)*. The terms of the compensating arrangements at *(date)* were:

EXAMPLES:

1. The Company has been expected to maintain an average compensating balance of 20 percent of its average loan understanding, as determined from the financial institution's ledger records adjusted for estimated average uncollected funds.
2. The Company has been expected to maintain an average compensating balance of \$100,000 during the year, as determined from the financial institution's ledger records without adjustment for uncollected funds.
3. The Company has been expected to maintain a compensating balance, as determined from the financial institution's ledger records without adjustment for uncollected funds, of 15 percent of its outstanding loans plus 10 percent of its unused line of credit.
4. The Company has been expected to maintain as a compensating balance noninterest bearing time deposits of 10 percent of its outstanding loans.

In determining compliance with compensating balance arrangements, the Company uses a factor for uncollected funds of ____ *(business)* *(calendar)* days.¹

There *(were the following)* *(were no)* changes in the compensating balance arrangements during the *(period)* and subsequently through the date of this letter.

The Company *(was)* *(was not)* in compliance with the compensating balance arrangements during the *(period)* and subsequently through the date of this letter.

There *(were the following)* *(were no)* sanctions *(applied or imminent)* by the financial institution because of noncompliance with compensating balance arrangements.²

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

¹ Not applicable if compensating balances are based on the financial institution's ledger records without adjustment for uncollected funds. If some other method is used for determining collected funds for compensating balance purposes, the method used should be described.

² Applicable only if the financial institution has applied sanctions during the *(period)* or notified the Company that sanctions may be applied. Indicate details.

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.

.27 Confirmation of Lines of Credit

[Date]

Financial Institution Official*
First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of *(name of client)* as of *(balance-sheet date)* and for the *(period)* then ended, we have advised our independent auditors of the information listed below, which we believe is a complete and accurate description of our line of credit from your financial institution as of the close of business on *(balance-sheet date)*. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other lines of credit from your financial institution comes to your attention, please include such information below.

The Company has available at the financial institution a line of credit totaling \$(*amount*). The current terms of the line of credit are contained in the letter dated *(date)*. The related debt outstanding at the close of business on *(date)* was \$(*amount*).

The amount of unused line of credit, subject to the terms of the related letter, at *(date)* was \$(*amount*).

Interest rate at the close of business on *(date)* was ____ %.

Compensating balance arrangements are _____

This line of credit supports commercial paper (or other borrowing arrangements) as described below:

* This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the lines of credit. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

Please confirm whether the information about lines of credit presented above is correct by signing below and returning this letter directly to our independent auditors (*name and address of CPA Firm*).

Sincerely,

[*Name of 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.

.28 Related-Party Confirmation

[Date]

[Name]

[Address]

In connection with an audit of our financial statements, please furnish answers to the attached questionnaire, sign your name, and return the questionnaire in the enclosed envelope directly to our auditors (*name and address of auditors*). The questionnaire is designed to provide the auditors with information about the interests of officers, directors, and other related parties in transactions with our Company.

Please answer all questions. If the answer to any question is "yes," please explain. Certain terms used in the questions are defined at the end of the questionnaire.

Very truly yours,

[Client's Authorized Signature]

[Title]

[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 revert title in himself or herself at once or at some future time are also considered as being beneficially owned.

.29 Safe Deposit Box Access Confirmation

[Date]

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]

.30 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]

[The next page is 7301.]

AAM Section 7300

Inquiries to Legal Counsel^A

.01 Illustrative Inquiry Letter to Legal Counsel^B

[Prepared on Client's Letterhead (see Note C)]

[Date (see Note D)]

[Name of Lawyer]
[Address of Lawyer]

Dear _____ :

In connection with an audit of our financial statements at (*balance-sheet date*) and for the (*period*) then ended, management of the Company has prepared, and furnished to our auditors (*name and address of auditors*), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (*balance-sheet date*) and during the period from that date to the date of your response.

Pending or Threatened Litigation

(excluding unasserted claims)

[Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

Unasserted Claims and Assessments

(considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)

[Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement dis-

closure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the company, such as guarantees of indebtedness of others.]

Very truly yours,

[Authorized Signature for Client]

Notes: (A) If a client has not needed to retain legal counsel, the auditor may express an unqualified opinion on the financial statements even though he has not obtained a letter from legal counsel of the Company. In these circumstances, the auditor should obtain written representation from the Company that legal counsel has not been retained for matters concerning business operations that may involve current or prospective litigation.

(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]

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.

[The next page is 7401.]

AAM Section 7400

Management Representations and Representation Letters

.01 Statement on Auditing Standards (SAS) No. 85, *Management Representations*, as amended by SAS Nos. 89 and 99 (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. Management's belief that the effects of any uncorrected financial statement misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are

immaterial, both individually and in the aggregate, to the financial statements taken as a whole.* (A summary of such items should be included in or attached to the letter.)"

- h. Management's acknowledgement of its responsibility for the design and implementation of programs and controls to prevent and detect fraud.
- i. Knowledge of fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.
- j. Knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.
- k. Plans or intentions that may affect the carrying value or classification of assets or liabilities.
- l. Information concerning related-party transactions and amounts receivable from or payable to related parties.
- m. Guarantees, whether written or oral, under which the entity is contingently liable.
- n. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the AICPA's Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.
- o. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
- p. Unasserted claims or assessments that the entity's lawyer has advised are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies* (AC C59).***
- q. Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
- r. Satisfactory title to assets, liens or encumbrances on assets, and assets pledged as collateral.
- s. Compliance with aspects of contractual agreements that may affect the financial statements.

Subsequent Events

- t. Information concerning subsequent events.

The representation letter ordinarily should be tailored to include additional appropriate representations from management concerning matters specific to the entity's business or industry.

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

* If management believes that certain of the identified items are not misstatements, management's belief may be acknowledged by adding to the representation, for example,

"We do not agree that items XX and XX constitute misstatements because [description of reasons]."

** SAS No. 47 states that the auditor may designate an amount below which misstatements need not be accumulated. Similarly, the summary of uncorrected misstatements included in or attached to the representation letter need not include such misstatements. The summary should include sufficient information to provide management with an understanding of the nature, amount, and effect of the uncorrected misstatements. Similar items may be aggregated.

*** If the entity has not consulted a lawyer regarding litigation, claims, and assessments, the auditor normally would rely on the review of internally available information and obtain a written representation by management regarding the lack of litigation, claims, and assessments; see Auditing Interpretation No. 6, *Client Has Not Consulted a Lawyer* (AU section 9337.15-17).

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, 20X1 and 20X0, and the related statements of income and retained earnings and cash flows for the years then ended." The written representations to be obtained should be based on the circumstances of the engagement and the nature and basis of presentation of the financial statements being audited.

.09 If matters exist that should be disclosed to the auditor, they should be indicated by modifying the related representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. . ." In appropriate circumstances, item 9 could be modified as follows: "The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except for its plans to dispose of segment A, as disclosed in Note X to the financial statements, which are discussed in the minutes of the December 7, 20X1, meeting of the board of directors." Similarly, if management has received a communication regarding an allegation of fraud or suspected fraud, item 8 could be modified as follows: "Except for the allocations discussed in the minutes of the December 7, 20X1, meeting of the board of directors (or disclosed to you at our meeting on October 15, 20X1), we have no knowledge of any allegations of fraud or suspected fraud affecting the company received in communications from employees, former employees, analysts, regulators, short sellers, or others."

.10 The qualitative discussion of materiality used in the illustrative letter is adapted from FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*.

.11 Certain terms are used in the illustrative letter that are described elsewhere in authoritative literature. Examples are fraud, in SAS No. 99, *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 accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the (consolidated) financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

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

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

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted the United States of America.
2. We have made available to you all—
 - a. Financial records and related data.
 - b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.
3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.
4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
7. We have no knowledge of any fraud or suspected fraud affecting the entity involving—
 - a. Management,
 - b. Employees who have significant roles in internal control, or
 - c. Others where the fraud could have a material effect on the financial statements.
8. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.
9. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
10. The following have been properly recorded or disclosed in the financial statements—
 - a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.

- b. Guarantees, whether written or oral, under which the company is contingently liable.
- c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with 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.)

11. There are no—

- a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
- b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.¹
- c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.

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

13. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

[Add additional representations that are unique to the entity's business or industry. (See paragraph 7 and Appendix B, "Additional Illustrative Representations," of SAS No. 85).]

[Add any representations related to new accounting or auditing standards that are being implemented for the first time.]

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

[Name of Chief Executive
Officer and Title]

[Name of Chief Financial
Officer and Title]

Notes: Depending on the nature, materiality, and complexity of fair values, management representations about fair value measurements and disclosures contained in the financial statements also may include representations about:

- The appropriateness of the measurement methods, including related assumptions used by management in determining the fair value and the consistency in application of the methods.
- The completeness and adequacy of disclosures related to fair values.
- Whether subsequent events require adjustments to the fair value measurements and disclosures included in the financial statements.

¹ 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.

[Source: SAS No. 101, paragraph 49 (AU section 328.49)]

See Appendix C, of SAS No. 100, *Interim Financial Information*, for Illustrative Management Representation Letters for a Review of Interim Financial Information.

[Source: SAS No. 100, Appendix C (AU section 722.56)]

.14 Illustrative Representation Letter—Audit of Personal Financial Statements

[Date]

[To the Independent Auditor]

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

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

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

1. The financial statements referred to above are fairly presented in conformity with generally accepted accounting principles.
2. We have made available to you all financial records and related data.
3. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
4. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
5. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
6. We have no knowledge of any fraud or suspected fraud affecting the entity involving—
 - a. Us.
 - b. Others where the fraud could have a material effect on the financial statements.
7. We have no knowledge of any allegations of fraud or suspected fraud affecting us received in communications from analysts, regulators, short sellers, or others.
8. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
9. The following have been properly recorded or disclosed in the financial statements:
 - a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
 - b. Guarantees, whether written or oral, under which we are contingently liable.
 - c. Significant estimates and material concentrations known to us that are required to be disclosed in accordance with 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.]

10. There are no—

- a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
 - b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.¹
 - c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.
11. We have satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.
12. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

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

(James Person)

(Jane Person)

¹ 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 modifying the related representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. . . ."

[Firm's Letterhead]

[Date]

To [Auditor]

In connection with your audit(s) of the [identification of financial statements] of [name of entity] as of [dates] and for the [periods] for the purpose of expressing an opinion as to whether the (consolidated) financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [name of entity] in conformity with generally accepted accounting principles, you were previously provided with a representation letter under date of [date of previous representation letter]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.

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

[Name of Chief Executive
Officer and Title]

[Name of Chief Financial
Officer and Title]

[The next page is 7501.]

AAM Section 7500

Communication With Audit Committees

.01 Illustrative Communication With Audit Committees

Addressee:^{*}

Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees*, as amended by SAS No. 89, *Audit Adjustments*, and SAS No. 90, *Audit Committee Communications*, (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, 20X2 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;¹
3. Adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process.
4. Uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
5. In connection with an SEC engagement, the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting. (See SAS No. 90 (AU section 380.11) for further information.)

^{*} Audit Committee, or other formally designated oversight group which is equivalent to the audit committee such as a finance committee or budget committee.

¹ In January 2003, the Auditing Standards Board issued SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AU section 328), which states that certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. According to SAS No. 101, paragraph 50 (AU section 328.50), the auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

6. Other information presented by management that is included with the entity's audited financial statements. The auditor should discuss the nature of his/her responsibility for such information with the audit committee,* including procedures performed, if any, and the results;
7. 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;
8. Auditor's views about any accounting or auditing matters discussed by management with other auditors (opinion shopping);
9. Major discussions by management with the auditor about the initial or continued retention of the auditor; and
10. 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 Nos. 87, 89, and 90 (AU section 380)]

Note: SAS No. 61 (AU section 380), is required to be followed for (1) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee) and (2) all Securities and Exchange Commission (SEC) engagements.

* Audit Committee, or other formally designated oversight group which is equivalent to the audit committee such as a finance committee or budget committee.

.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 20XX. 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,

[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 20XX, 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, 20X0, and the related statements of income, retained earnings, and cash flow for the year then ended. The financial statements were audited as of the financial statement date and the audit procedures performed were completed on March 28, 20X1 (*audit report date*). No additional audit procedures were performed subsequent to March 28, 20X1.

The audit was conducted in accordance with generally accepted auditing standards. 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 20____. 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 CPAs with an overview of recent economic, industry, regulatory, and professional developments that may affect audits and other engagements they perform. The material in this section has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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AAM Section 8010

Audit Risk Alert—2002/03

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate. This Alert is an important tool in helping you identify the significant business risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and current accounting, auditing, and professional developments.

.02 If you understand what is happening in the business environment and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that knowledge and understanding it.

The U.S. Business Environment

Weak Recovery and an Uncertain Future

.03 The United States economy is experiencing a mild recovery after weathering a mild recession. Its future is uncertain, and some economic indicators point to further weakness. Corporate earnings reports for the first three quarters of 2002 were weak in many sectors. In addition, consumer confidence is showing signs of weakening. The federal funds rate is at 1.25 percent, the lowest level in over forty years.

.04 According to the Commerce Department's figures, the economy was actually shrinking for the first three quarters of 2001. The United States was in a recession long before 11-September. Undoubtedly, the impact of the terrorist attacks will ripple through the economy for some time. It cost the U.S. economy thousands upon thousands of jobs, and somewhere between \$75 billion and \$100 billion in reduced output. A number of industries, such as airlines and tourism, suffered tremendously and have not fully recovered.

.05 Although the 2001 recession lasted six months longer than originally thought, it is still considered a mild recession by historical standards. Unfortunately, the recovery has been equally weak. Large inventory adjustments caused the gross domestic product (GDP) to soar in the first quarter of 2002 to an annual average growth of 5 percent. Many had expected a slowdown after that level of growth, but few expected a second-quarter number of 1.3 percent. The economy rebounded in the third quarter of 2002 and grew at a 3.1-percent annual rate. However, excluding motor vehicles, third-quarter growth was 1.5 percent. Economists expect the economy to grow at about 2 percent in the fourth quarter. The historical average for economic growth at this stage of the recovery is in excess of 5 percent.

.06 Attempts to forecast future economic conditions are muddled by the probability of military intervention in Iraq by the United States. Experts tend to believe that if the war is short, no serious economic harm will occur; in fact, a quick victory in Iraq could prove beneficial to the economy. A protracted war, however, could depress business, consumer, and investor confidence, sending the economy into a recession.

.07 This recovery is not typical of recoveries the country has experienced since World War II. In the past, job growth would have been sizable. Although unemployment fell to 5.6 percent in September of 2002, the trend for most of 2002 has been flat. The government created most of the new jobs, and the private sector actually decreased slightly. Employers are reluctant to hire new employees because of the tumbling stock market and uncertainty over the economy's health.

Stock Market Woes

.08 The downward slide of the Dow Jones Industrial Average (DJIA), the National Association of Securities Dealers Automated Quotation (NASDAQ) Composite Index, and the Standard & Poor's 500 Stock Index (S&P 500) that began in 2000 continued through the first three quarters of 2002. Throughout the year, analysts were evaluating economic conditions and drastic declines in stock market indices, comparing them to prior periods in an attempt to determine whether the economy had finally reached rock bottom. But the stock market kept surprising everyone with further declines that sent various indices to record lows. The DJIA ended the third quarter of 2002 at 7591.93, sinking to a four-year low; the NASDAQ ended at 1172.06, reaching a six-year low; while the S&P 500 fell to 815.28, which is less than 20 points above a five-year low it hit in July 2002. All of these indicators are significantly below the low levels triggered by panic immediately following the events of 11-September.

Falling Dollars

.09 The currency markets, too, have experienced nail-biting dips. Like stocks, the dollar was hit hard by the forecasts of weak growth. The dollar went into a nosedive against the euro, sinking 18 percent from mid January to mid July of 2002. In the third quarter of 2002, however, the dollar rebounded and strengthened.

.10 Many experts believe that the U.S. dollar cannot remain strong much longer and that a decline in the dollar's exchange rate will occur either in an orderly or a chaotic fashion in the near future. A falling dollar could slow real GDP growth, consumption growth, and investment growth. Moreover, a falling dollar could lead to increased interest rates and higher inflation. On the flip side, however, a weakening dollar would boost U.S. exports and lessen the nation's dependence on foreign investment.

Consumer Spending, Home Buying, Federal Outlays, and Technology Investment Help Economy

.11 Consumer spending and housing posted nice gains in the first two quarters of 2002, which was important inasmuch as consumption is two-thirds of American economic output. Businesses have been posting modest increases in spending on computers, software, and equipment, suggesting that the rut in technology investment may be drawing to an end. In addition, car sales were at near-record levels, thanks to the cheap financing offered by Detroit. A strong housing market has also fueled consumption. Falling interest rates raised house prices and refinancing activity allowed consumers to put some extra cash into their wallets. No doubt, low interest rates have sparked the demand for housing and cars, which has helped support growth this year. Nevertheless, some economists are concerned that the current strong demand for autos amounts to borrowing from future demand.

.12 The volatility in the stock markets has sapped consumer confidence, but the way consumers spend does not always reflect how they feel. Data released during the third quarter of 2002 indicate that outstanding consumer debt rose, but forecasts of consumer spending are somewhat pessimistic. Household real income, after taxes and inflation, has grown 5 percent during the past year. Tax breaks and falling inflation have offset labor-market weakness. In fact, real income is growing faster than the pace of real consumer spending.

Big Government Is Back

.13 Not only have consumers been spending; so too has the U.S. government. Just two years ago, Washington was looking at a \$5.6 trillion budget surplus through 2010. Now, fiscal 2002 will post a deficit and the federal government is engaged in a tremendous spending spree. To be sure, the attacks of 11-September demanded a much-needed increase in spending on national defense and homeland security. But most of the increase in federal spending has nothing to do with rebuilding the military or shoring homeland defense. Rather, massive amounts of tax dollars are being spent on a large and varied number of programs favored by Congress, including farm subsidies, unemployment compensation, education and health care programs.

Risk of Deflation Could Harm Economic Future

.14 Falling inflation is certainly welcome news for most consumers. Americans are benefiting from the lower prices of a variety of goods and services. For example, personal computer prices fell 28.9 percent. However, if deflation extends into other segments of the economy, it could be a major problem. Falling prices squash corporate profits, forcing companies to fire employees and tighten salaries. Both the Great Depression of the 1930s and the Japanese economic slump since 1990 were accompanied by severe deflation. Although most economists are not predicting the doom and gloom of the 1930s, the risk of deflation is real. The risk will become more real if the high housing prices in the United States begin to fall. Some economists and real estate experts are concerned that home prices have risen too fast and could fall.

Resiliency of American Economy

.15 It is important to be able to see the forest through the trees. Terror attacks, accounting scandals, and falling stock prices notwithstanding, the American economy has proven to be quite resilient. Much of the economic data remain well within the realm of the “slow but steady” recovery theme; and although the economic future is weighed down with uncertainty, the underpinnings of the U.S. economy remain strong.

Accounting Scandals and Audit Failures—Lessons Learned

.16 2002 will be remembered as an infamous year for corporate America and the accounting profession. We are all familiar with the news stories that have been dominating the financial headlines—accounting irregularities, fraud, audit shortcomings, out-of-control business executives, bankruptcies, crashing stock market valuations, Enron, Worldcom, Arthur Andersen, congressional hearings, Sarbanes-Oxley. The revelations of financial abuse and high-profile business failures were a traumatic blow to the accounting profession, corporate America, and the stock market.

.17 Business executives, accounting professionals, and regulators are all still digesting the business scandals of 2002 and their ramifications, as a different business environment and accounting profession emerge. Already, businesses are shying away from complex financial structuring and complicated off-balance-sheet arrangements as investors punish companies with heavy loads of off-balance-sheet debt or even the slightest indication of accounting chicanery. Moreover, new legislation has been enacted, unleashing sweeping reforms in corporate America and the accounting profession (See the “Professional Issues” section of this Alert.)

What Auditors Need to Do

Maintain the Mind-Set That Manipulating Financial Reporting Is Not Uncommon

.18 In light of what has been transpiring in the business world and the accounting profession, auditors need to come to an awareness that many, many companies massage their financial reporting by using creative, aggressive, or inappropriate accounting techniques. In an effort to meet earnings targets, live up to the expectations of the marketplace and third parties, and increase personal compensation, management may:

1. Commit fraudulent financial reporting.
2. Unreasonably stretch accounting rules to significantly enhance financial results.
3. Follow appropriate accounting rules, but use loopholes to manage financial results.

Auditors most frequently encounter items 2 and 3 in the preceding list. The auditor’s report expresses an opinion as to whether the financial statements “present fairly . . . in conformity with generally accepted accounting principles.” It seems that in many places, the “present fairly” criterion has become subordinate

to “in conformity with GAAP.” That is, whether some entities make a case that since generally accepted accounting principles (GAAP) do not prohibit a particular accounting method, it must be acceptable, without considering whether the accounting will result in a fair presentation of the financial position, results of operations, and cash flows. The quality of financial statements becomes eroded when accounting choices are made to achieve a predetermined result other than improving the usefulness of the information to decision makers. Thus, the *choice* of accounting principles, in addition to their application, becomes crucial for auditors to consider. Besides checking off all of the GAAP boxes, one must determine whether the financial reporting ultimately reflects economic reality.

Reach Back to Core Values on Every Engagement

.19 In addition to maintaining a mind-set that managing earnings and engineering financial reporting is not uncommon, auditors need to approach their engagements with:

- A responsibility to the public interest
- A rigorous commitment to integrity
- A passion for getting it right
- A commitment to principles and a zeal for applying them
- The willingness to say *no* to unsound accounting practices

Rediscover Professional Skepticism on Every Audit

.20 Due professional care requires the auditor to exercise professional skepticism. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Auditors may be tempted to put professional skepticism in the back of their minds, making it a concept that gets inadequate attention because its practical application is difficult. But an auditor must rediscover professional skepticism and carry it into each and every audit. An auditor’s attitude can increase the likelihood of finding misstatements.

.21 ***Acknowledge and Challenge Assumptions.*** Many auditors are inclined to assume good intent and tend to rely too heavily on what management tells them. In fact, many audit failures do not stem from an auditor’s inability to uncover a problem, but rather, from an auditor’s willingness to accept a client’s rationalization as to why they should pass on the problem. Assumptions can limit awareness. Assumptions are not inherently bad and are absolutely essential to functioning in the real world. Nevertheless, they hold a danger; an auditor who is faced with information that conflicts with his or her assumptions is apt to resolve the inconsistency by resisting the new information. If information does not fit with what we “know,” we look for a way to make it fit. The auditor must instead set aside existing beliefs about management’s integrity and honesty by periodically challenging the assumptions he or she has made about a client’s management, business, and financial reporting. Use the brainstorming session during the planning phase of the audit to identify assumptions about the client and sensitize engagement team members to their preconceived notions and possible alternative realities.

.22 ***Critically Evaluate Evidence.*** Auditors must also remember to identify and challenge their own assumptions when evaluating audit evidence. Professional skepticism must be rediscovered when assessing the competency and sufficiency of audit evidence. For instance, the auditor should not accept draft contracts or rely on copies of key documents. Auditors should reconcile evidence that is inconsistent and corroborate key assumptions in estimates.

.23 ***Guidance on Professional Skepticism.*** Excellent practical guidance on professional skepticism can be found in the AICPA Practice Aid, *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*. Additional guidance can also be found in the AICPA Practice Alert 98-2, *Professional Skepticism and Related Topics*.

Attention-Grabbers for Auditors: Spotting the Early Warning Signs

.24 Auditors can learn valuable lessons from the recent accounting scandals and audit failures. These lessons serve to improve the quality of financial statement audits by helping auditors identify possible warning signs and risks of accounting chicanery, fraud, inaccurate financial reporting, and business failure. In addition, these lessons serve to improve audit quality by fostering an awareness of what audit procedures may be key to addressing the risks and issues that were prevalent in the recent accounting scandals.

.25 The section of this Alert entitled “Audit and Accounting Issues Arising From Current Risks” presents important guidance on accounting and auditing issues stemming from the recent business scandals as well as those stemming from the current economic and business environment. You should familiarize yourself with the items discussed in that section.

.26 One could fill pages and pages listing situations, factors, events, and circumstances indicative of fraud, aggressive accounting, and possible business failure. Such lists can be found in countless professional publications and Web sites. Indeed, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), and its accompanying Practice Aid, *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*, provide first-rate knowledge about fraud risk factors. Auditors should avail themselves of that knowledge by reading SAS No. 99, its accompanying practice aid, and the many other existing sources of guidance that exist.

.27 In addition, presented below is a list of circumstances and observations that should grab the attention of an auditor if he or she observes these situations at a client. These “attention-grabbers” have been compiled based on an assessment of the recent accounting scandals and business failures that have occurred.

Key Attention-Grabbers

.28

1. *A company culture of arrogance.* Management that engages in deceptive accounting practices or fraudulent financial reporting often exhibits high levels of arrogance, pride, greed, and hubris. They often have a reputation for being unusually aggressive, for taking high risks, living close to the edge, and swinging for the fences in business dealings. Effective internal control starts with a proper “tone at the top.” Culture and values are critical elements of control because all other controls are derived from them. Culture drives behavior. A few bad apples will flourish in a culture of arrogance, excessive risk taking, and little accountability. And a few bad apples can cause a company to come crashing down.
2. *Accounting policies that rely heavily on management’s judgment or seem too aggressive.* The manner in which accounting principles are selected and applied affect the accuracy, transparency, understandability, and usefulness of the financial statements. If the accounting methodology for a transaction or event involves different alternatives or a good degree of estimating and judgment, or represents an evolving area in accounting, or is unclear, unusual, or not fully supportable, then management has the tools and the temptation to manipulate financial reporting. These tools, stemming from the selection and application of accounting principles, can be used to tweak earnings and manipulate other accounts and transactions to report the financial results desired by management and conceal critical information. Abusing the selection and application of accounting principles can lead to a situation in which an entity’s financial statements do not reflect the underlying economic condition. The accounting principles selected by management should enhance the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.
3. *Ineffective audit committees and board governance.* The audit committee is the ultimate monitor of the financial reporting process. It therefore stands to reason that an ineffective committee or its equivalent, or the lack of one, can seriously undermine proper financial reporting. Be on the lookout for audit committees that are not independent of the company, meet infrequently, lack adequate financial

expertise, do not hear *directly* from internal auditors, and do not closely monitor sensitive company programs, such as a corporate loan program for senior management.

4. *Overly centralized control over financial reporting.* If one member of senior management or a small group of senior management holds a tight grip over the financial reporting process and goes to extremes to exclude prying eyes, internal control suffers and the opportunity for fraudulent or questionable financial reporting emerges.
5. *Ratios and benchmarks significantly different from industry averages.* An auditor needs to ask why an entity's financial results are markedly different from other entities in its industry. This kind of benchmarking research and analysis may not be readily available or apparent. However, this kind of information can point to a possible business failure or going-concern problem or to the manipulation of the accounting and financial reporting process.
6. *Cash flow from operations that bears little relationship to reported earnings.* If reported earnings do not correspond to the actual cash flowing into an entity, auditors should take note. If management is manipulating the accounting process to manage earnings, it may show up in the disparity between operating cash flow and income statement earnings. Also, companies go bankrupt because they run out of cash. Keep an eye on the cash-flow statement when assessing an entity's ability to continue as a going concern.
7. *Compensation plans geared toward enriching executives rather than generating profits.* With their own compensation tied to operating or financial targets, management can push hard on personnel throughout the company to meet what may be overly optimistic goals. A high-pressure environment can create an incentive to adopt practices that may be too aggressive or inconsistently applied. At some point, the motivation driving earnings management can be strong enough to encourage individuals with the right opportunity to move beyond acceptable practices. Don't underestimate greed. If greed is evident and management is focused on how much money they are going to make, auditors should heighten their sense of professional skepticism and adjust their audit procedures accordingly.
8. *Significant insider trading.* A significant sell-off of company stock by senior management may indicate that they believe the stock is overvalued, the financial reporting does not portray the true economic value of the entity, or that the company may be heading toward failure.
9. *Difficulty explaining how the company actually makes money.* Simply put, it may be unclear exactly how a company derives its profits and its cash. Or, at the end of the day, it may be the case that a company just does not make very much money. In some cases, an entity may be involved in numerous businesses and complicated operations, and yet after looking at all that activity, one is hard-pressed to explain how the entity generates cash.
10. *Predictions by management are at odds with industry trends.* Management may base their assumptions, estimates, accounting principles, business decisions, and explanations to auditors on predictions, forecasts, and beliefs about the current and future business environment that contradict actual industry trends, credible research, and what other entities in the industry are doing or predicting.
11. *Undisciplined acquisition growth.* Senior management may acquire businesses and assets more for the sake of accumulating assets than for the overall good of the company. Acquiring businesses and assets too rapidly can lead to many challenges and risks, including integrating disparate operations, melding internal control processes, and meeting expanded financing needs. In addition, rapid acquisition growth may outstrip the ability of a company's financial systems to remain under effective internal control. If management cares more about acquiring new assets than about making the existing ones perform properly, serious business, liquidity, and financial reporting problems can arise.
12. *Departure of key senior management personnel.* If key people leave a company suddenly or if a number of senior management personnel have resigned, this may be a warning sign of possible trouble at the entity. Are these resignations unexplained? Is the suddenness or number of resignations unusual? Do these key people know something about the company's financial future that is causing them to jump ship? An auditor needs to pay attention to significant or unusual management departures.

13. *Relationships and credibility with customers, creditors, and other third parties declining.* Information pointing to a deterioration in a company's business relationship with its customers, creditors, suppliers, or other parties may signal financial difficulties or inappropriate activities at the company.
14. *Prolonged periods of success.* Yes, even too much success can be a dangerous thing. Many of the big-name companies experiencing difficulties today ran into trouble after long periods of financial success and business growth. As the years of prosperity add up, management may become set in its ways. Assumptions about the future of the industry and the company may be severely clouded by the past experience of uninterrupted success. Management may let its guard down and become incapable of envisioning an environment of subsiding financial prosperity. Does management face reality or merely explain it away or ignore it? Assumptions and estimates used in financial reporting, and assumptions and projections used in business decisions need to be questioned and examined with a clear perception of the true conditions of the economy, the industry, and the company.
15. *Failure to listen to key people within the company.* Senior management may be so focused on achieving stock price and earnings goals that they may fail to heed the advice of key employees warning them of troubling consequences and developments. Whether it be accounting personnel, or employees involved in operations, or those working in research and development, these people may be aware of inappropriate situations or risky developments that result from management's aggressive efforts to meet certain financial goals. Management may dismiss warnings from these people, lest the financial targets not be achieved.

Auditing and Accounting Issues Arising From Current Risks

.29 The economic and business environment is a factor affecting the accuracy of your client's financial statements, and affecting issues of fraud and going concern. Understanding the economic and business environment in which your client operates should constitute a large part of your audit planning. You should understand your client's specific business environment and how the overall economic situation and business issues described in this Alert are affecting your client. Economic performance varies across geographic regions and industries, and among companies, even within the same industry. Therefore, auditors need to focus specifically on the business environment of each client and address each client's particular risks accordingly.

Identifying Risks That May Result in Material Misstatements

.30 The current economic and business environment lead to challenging conditions for companies due to the potential deterioration of operating results, increased external scrutiny, and reduced access to capital. These conditions can result in increased incentives for companies to adopt practices that may be incorrect or inconsistently applied in an effort to address perceived expectations of the capital markets, creditors, or potential investors. In addition, a declining business environment can contribute toward the impairment of assets and deterioration in the value of assets.

.31 Moreover, financial reporting scandals and the high-profile failures of major corporations have rocked the business and accounting world. Fraudulent financial reporting, and aggressive or questionable accounting seem to be on the rise. Auditors appear to be facing risks from many different quarters. During such times, professional skepticism should be heightened and the status quo should be challenged.

.32 As you plan your audits, you should obtain an understanding of each client's internal controls and its business environment sufficient to assess what significant risks give rise to problems that may cause misstatements in the financial statements.

.33 The general economic and business environment, along with the recent spate of business failures and accounting scandals, give rise to certain audit and accounting issues and concerns that could affect an entity's financial statements. Some of the more significant ones are presented in the following table and are discussed below.

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Fraudulent Financial Reporting

.34 Many of the issues, topics, and risks discussed in this Alert involve matters of fraudulent financial reporting. As such, auditors should read the individual topics within this Alert to obtain an awareness of matters of fraud that may need to be addressed on their audits. The weak economic and business environment can generate increased pressure on management at many companies. The stress of achieving earnings goals and battling fierce competition during weak economic periods can motivate management to fraudulently report financial results. Consequently, an increased risk of fraudulent financial reporting may exist at many entities.

New Fraud Standard and Implementation Guide Issued

.35 In September 2002, the AICPA Auditing Standards Board (ASB) issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, which gives auditors expanded guidance for detecting material fraud. SAS No. 99 supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU secs. 110, 230, 312, and 316A), and while the new standard may carry the same title as SAS No. 82, auditors need to recognize that it is clearly more far-reaching than its predecessor. SAS No. 99 should substantially change auditor performance, thereby improving the likelihood that auditors will detect material misstatements due to fraud. See the section of this Alert entitled “New Auditing, Attestation, Quality Control Pronouncements, and Other Guidance,” for more detailed information about SAS No. 99.

.36 SAS No. 99 is extremely comprehensive and touches on many elements of the audit process. It cannot be reduced to a checklist or form. The effective implementation of SAS No. 99 will require auditors to *audit smarter* and think more creatively when they audit. Engagement teams who plan to implement the new

standard by obtaining an updated version of a generic audit program will be doing themselves and their clients an injustice. The effective implementation of SAS No. 99 will force you to rethink how you plan and perform your audits. With that in mind, the AICPA has developed a practice aid to help practitioners implement SAS No. 99. The practice aid is entitled *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*. See the “New Auditing, Attestation, Quality Control Pronouncements, and Other Guidance,” section of this Alert for more information.

Viability and Liquidity Risks

.37 An entity’s sensitivity to negative changes in economic conditions, such as reductions in consumer spending and business investment, layoffs, and a declining stock market, can often result in business failure. In addition, fraudulent and criminal activities engaged in by management, partnered with deceptive accounting methods, can remain hidden at companies and eventually lead to business failure. Accordingly, you should be alert to conditions and events which, when considered in the aggregate, indicate that there could be substantial doubt about your client’s ability to continue as a going concern.

.38 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 product line, or (4) external matters, such as legal proceedings or loss of a principal supplier. Another condition that may raise doubt about an entity’s ability to continue as a going concern could be excessive and unusual reliance on external financing, rather than money generated from the company’s own operations. In such circumstances, auditors will have to consider whether, based on such conditions and events, there is substantial doubt about the entity’s ability to continue as a going concern.

Auditor’s Responsibilities Related to a Going-Concern Issue

.39 You should be aware of your 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 (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.

.40 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 the 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. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

.41 If there is substantial doubt about the entity’s ability to continue as a going concern, you 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 you obtain sufficient competent evidential matter to alleviate doubts about going-concern issues, then consideration should be given to the possible effects on the financial statements and the adequacy of the related disclosures. In particular, the auditor should consider the adequacy of the disclosures of those circumstances and events that originally gave rise to the auditor’s concern. If, however, after considering identified conditions and events, along with management’s plans, you conclude 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, you should refer to the specific guidance set forth in SAS No. 59.

Using Cash-Flow Analysis to Help Assess Going Concern

.42 To fully understand a company's viability as an ongoing concern, an auditor would do well to calculate a few simple ratios from data on the client's cash-flow statement. When it comes to liquidity analysis, cash-flow information is more reliable than balance-sheet or income statement information. Balance-sheet data are static—measuring a single point in time—while the income statement contains many arbitrary noncash allocations. In contrast, the cash-flow statement records the changes in the other statements and nets out the bookkeeping artifice, focusing on what shareholders and other interested parties really care about, that is, the cash available for operations and investments.

.43 Numerous cash-flow ratios are available to help assess a client's solvency, liquidity, and the viability of a client as a going concern. Presented below are two ratios that help spotlight a company's viability as a going concern.

.44 **Funds Flow Coverage Ratio.** The numerator of the funds flow coverage (FFC) ratio consists of earnings before interest and taxes plus depreciation and amortization (EBITDA). The denominator consists of interest plus tax-adjusted debt repayment plus tax-adjusted preferred dividends. To adjust for taxes, divide by the complement of the tax rate. All of the figures in the denominator are unavoidable commitments.

.45 An auditor can use the FFC ratio as a tool to evaluate the risk that a company will default on its most immediate financial commitments, that is, interest payments, short-term debt, and preferred dividends. If the FFC ratio is at least 1.0, the company can meet its commitments—but just barely. If a company's FFC ratio is less than 1.0, the company must raise additional funds to meet current operating commitments. To avoid bankruptcy, it must keep raising fresh capital.

.46 **Cash interest coverage ratio.** The numerator consists of cash flow from operations, plus interest paid, plus taxes paid. The denominator includes all interest paid—short term and long term. The resultant multiple indicates the company's ability to make the interest payments on its entire debt load. A highly leveraged company will have a low multiple, and a company with a strong balance sheet will have a high multiple. Any company with a cash interest multiple less than 1.0 runs the immediate risk of potential default.

Special Advice on Related Parties and Recent Accounting Scandals

.47 The recent spate of business failures and accounting scandals in the news often involved related party issues, including:

- Multimillion dollar conflicts of interest between officers and senior management of a company and the company itself
- Conflicts of interest at firms that manage both hedge funds and mutual funds
- Undisclosed loan guarantees to outside parties closely related to the company
- Self-dealing by company officials who used the company as a personal bank
- Transactions serving no apparent business purpose but to enrich company insiders
- Hiding huge sums of debt and underperforming assets in controlled entities, such as partnerships

.48 Fraudulent financial reporting and misappropriation of assets are frequently perpetrated through the use of related parties. Moreover, financial statements can often be misleading and distorted without adequate disclosure of material related-party transactions. Related parties, such as controlled entities, principal stockholders, or management, can execute transactions that improperly inflate earnings by masking their economic substance or distort reported results through lack of disclosure, or can even defraud the company by transferring funds to conduit related parties and ultimately to the perpetrators.

Accounting and Auditing Guidance

.49 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 57, *Related Party Disclosures*, defines related parties and provides guidance on the disclosure of transactions with related parties. Transactions between related parties commonly occur in the normal course of business. Generally, financial statements must include disclosures of material related-party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. SAS No. 45, *Related Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 334), provides guidance on procedures that should be considered with respect to related parties when performing an audit of financial statements. Other important sources of authoritative accounting and auditing guidance exist regarding related parties.

Refer to the AICPA Toolkit

.50 The AICPA toolkit, *Accounting and Auditing for Related Parties and Related Party Transactions*, provides considerable in-depth guidance on accounting for and auditing related-party transactions. The toolkit describes the numerous sources of relevant accounting and auditing literature, including applicable Securities and Exchange Commission (SEC) regulation requirements. The toolkit can be obtained for free on the AICPA Web site at www.aicpa.org/public/download/news/relpty_toolkit.doc.

Specific Auditing Advice

.51 Given the prominent role of related-party transactions in many of the recent accounting scandals, this section includes specific advice to help auditors address and prevent similar related-party scandals in the future. Of course, auditors should consider the guidance discussed in the aforementioned toolkit and the guidance in the pronouncements discussed in that toolkit.

.52 The auditor should consider procedures to identify related-party relationships and transactions, and satisfy himself or herself that such relationships and material transactions are properly accounted for and adequately disclosed in the financial statements. The auditor should consider the possibility that related-party transactions might have been motivated by a desire to improve reported earnings or financial position or might have been motivated by fraud. Remember that related-party transactions lack the independent negotiations as to structure and price that are present in transactions with unrelated parties.

Special Advice on Identifying Related Parties and Related-Party Transactions

.53 SAS No. 45 includes specific audit procedures to help determine the existence of related parties. Auditors should follow that guidance. Remember that the number one rule for potentially identifying related parties and related-party transactions that management does not disclose to the independent auditor is simply to be alert to that possibility. As indicated in SAS No. 99, entities intent on fraudulently reporting financial results may use related-party transactions to perpetrate or conceal the fraud.

.54 The following examples of events may be indicative of transactions with undisclosed related parties and are commonly used in fraudulent financial reporting:

- Sales without substance, including funding the other party to the transaction so that the sales price is fully remitted
- Borrowing or lending on an interest-free basis or at a rate of interest significantly above or below the market rates prevailing at the time of the transaction
- Selling real estate at a price that differs significantly from its appraised value
- Exchanging property for similar property in a nonmonetary transaction
- Making loans with no scheduled terms for when or how the funds will be repaid

- Sales with a commitment to repurchase that, if known, would preclude recognition of all or part of the revenue
- Accruing interest at above-market rates on loans
- Loans to parties that do not possess the ability to repay
- Advancing company funds that are subsequently transferred to a debtor and used to repay what would otherwise be an uncollectible loan or receivable
- Services or goods purchased from a party at little or no cost to the entity
- Loans advanced ostensibly for a valid business purpose and later written off as uncollectible
- Payments for services never rendered or billed at inflated prices
- Sales at below-market rates to an unnecessary “middle-man” related party, who in turn sells to the ultimate customer at a higher price while the related party (and ultimately its principals) retain the difference
- Purchases of assets at prices in excess of fair-market value
- Sales arrangements in which the seller has a concurrent obligation to the buyer to purchase goods or services or provide other benefits
- Sale of land with arranged financing
- Sales of marketable securities at a significant discount from quoted market prices
- Agreements under which one party pays expenses on behalf of another party

In addition to the items above, also be aware that a company may recognize revenue on large, unusual transactions with another party conducted close to quarter-end. Consideration should be given to whether or not the two parties might be related in some way.

.55 Procedures that can be performed to help identify potential related parties and related-party transactions include the following:

- Review material cash disbursements, advances, and investments to consider whether the company provided funds to a related party.
- Discuss with tax and consulting personnel who have provided services to the client their knowledge of the client’s relationships and knowledge of related parties.
- Discuss with intermediaries (such as lawyers, predecessor auditors, and others providing professional services to the client) their knowledge of the identity of principal parties to material transactions.
- Use sources of information about principal parties to material transactions (such as newspapers, phone books, industry or trade publications, and the Internet) to search for information about key members of management and the company. For example, the Internet can be used to search for corporation and limited partnership records in which a particular person’s name appears.

.56 *Identification of an Unidentified Related Party.* When an undisclosed related party has been identified, the audit team should assess whether management’s failure to disclose was merely an oversight or a deliberate attempt to hide the relationship. If the latter, the auditor should reassess the overall audit scope and the ability to rely on management’s representations in other areas. If the auditor believes management can no longer be trusted, the best course of action, after consulting others in the firm designated as consultants in accounting and auditing matters, as well as legal counsel, may be to withdraw from the engagement.

Special Advice on Examining Related-Party Transactions

.57 In one recent, well-publicized, and particularly egregious case of management fraud, the company's board and the company's auditors failed to spot and examine loans to officers of the company that proved to be exorbitant and unauthorized. Once related parties are identified, the auditor should place emphasis on testing material transactions with parties known to be related or associated with the reporting entity. The auditor should apply the audit procedures he considers appropriate to determine the purpose, nature, and extent of the related-party transaction and the effect on the financial statements. In obtaining sufficient competent evidential matter, the auditor should extend the procedures beyond just inquiry of management. Procedures that should be considered include the following:

1. Obtain an understanding of the business purpose of the transaction.
2. Examine invoices, executed copies of agreements, contracts, and other pertinent documents, such as receiving reports and shipping documents.
3. Determine whether the transaction has been approved by the board of directors or other appropriate officials.
4. Test for reasonableness the compilation of amounts to be disclosed, or considered for disclosure, in the financial statements.
5. Arrange for the audits of intercompany account balances to be performed as of concurrent dates, even if the fiscal years differ, and for the examination of specified, important, and representative related-party transactions by the auditors for each of the parties, with appropriate exchange of relevant information.
6. Inspect or confirm and obtain satisfaction concerning the transferability and value of collateral.

In addition, the auditor may determine that extended procedures should be performed in order to fully understand the transactions. If so, the auditor should consider the following procedures:

1. Confirm transaction amount and terms, including guarantees and other significant data, with the other party or parties to the transaction.
2. Inspect evidence in possession of the other party or parties to the transaction.
3. Confirm or discuss significant information with intermediaries, such as banks, guarantors, agents, or attorneys, to obtain a better understanding of the transaction.
4. Refer to financial publications, trade journals, credit agencies, and other information sources when there is reason to believe that unfamiliar customers, suppliers, or other business enterprises with which material amounts of business have been transacted may lack substance.
5. With respect to material uncollected balances, guarantees, and other obligations, obtain information about the financial capability of the other party or parties to the transaction. Such information may be obtained from audited financial statements, unaudited financial statements, income tax returns, and reports issued by regulatory agencies, taxing authorities, financial publications, or credit agencies. The auditor should decide on the degree of assurance required and the extent to which available information provides such assurance.

Special Advice on Auditing Related-Party Disclosures

.58 Some of the recent accounting scandals and business failures involved related-party disclosures that were virtually indecipherable to investors. Furthermore, in one of the larger business failures, the notes to the financial statements asserted that related-party transactions were arm's-length, yet apparently the auditor failed to perform any procedures to test the reasonableness of that statement. Reliable and transparent financial reporting is particularly important in this troubled environment. This requires the special attention of CPAs to work with management and audit committees, when appropriate, to ensure that management's disclosure of related-party transactions are appropriately and completely disclosed in conformity with GAAP.

.59 If representations are made by management in their financial statement disclosures about transactions with related parties, the representations should not imply that the related-party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated. If such representations do imply this and the engagement team believes that the representation is unsubstantiated by management, it should, depending on materiality, express a qualified or adverse opinion because of a departure from GAAP. Remember that paragraphs 29 and 30 of Financial Accounting Standards Board (FASB) Statement No. 13, *Accounting for Leases*, and SEC regulation S-X 4-08(k) require disclosure of the nature and extent of leasing transactions between related parties.

Revenue Recognition

.60 Faced with an uncertain economic and business climate, management at some companies will be hard-pressed to generate profits and report favorable financial results. Accounting practices relating to revenue recognition may become more aggressive or even fraudulent as a result. Remember that many of the accounting scandals occurring of late involve accounting practices designed to artificially inflate revenues.

.61 Such improper accounting treatment ranges from stretching the accounting rules (for example, recognizing revenues before they are earned) to falsifying sales in an effort to manage earnings. Therefore, auditors need to pay attention to warning signals that may indicate increased audit risk with respect to revenue recognition and respond with appropriate professional skepticism and additional audit procedures.

.62 Because material misstatements due to fraudulent financial reporting often result from an overstatement or understatement of revenues, SAS No. 99 states that you should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.

Accounting Considerations

.63 The fundamental revenue recognition concept is that a company should not recognize revenue until realized or realizable and earned by the company. FASB Statement of Accounting Concepts No. 6, *Elements of Financial Statements*, defines revenue as:

Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

Additional guidance with respect to revenue recognition is found in the following pronouncements:

- Accounting Research Bulletin (ARB) No. 45, *Long-Term Construction-Type Contracts*
- FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*
- SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*
- SOP 97-2, *Software Revenue Recognition*, and SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions*
- *Technical Practice Aids*, Section 5100, "Revenue Recognition"
- SOP 00-2, *Accounting by Producers or Distributors of Films*
- Numerous Emerging Issues Task Force (EITF) Issues
- SEC Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*

.64 **Criteria for Revenue Recognition.** Transactions should meet the following criteria before revenue is recognized:

- There is persuasive evidence of an arrangement.
- Delivery has occurred or services have been rendered.
- The seller's price to the buyer is fixed or determinable.
- Collectibility is reasonably assured.

Although these criteria are general, they provide guidance for revenue recognition relating to most traditional business models. For public companies that do not employ traditional business models, such as e-commerce companies, SAB No. 101 provides additional guidance on these revenue recognition issues:

- Timing of approval for sales agreements
- "Side" arrangements to the master contract
- Consignment or financing arrangements
- Criteria for delivery (bill and hold sale)
- Layaway programs
- Nonrefundable, up-front fees
- Cancellation or termination provisions
- Membership fees or services
- Contingent rental income
- Right of return

.65 SAB No. 101 and the SEC's *SAB No. 101 Frequently Asked Questions (FAQ)* (www.sec.gov/info/accountants/sab101faq.htm) are valuable and comprehensive sources of guidance on revenue recognition.

.66 *FASB Project.* The FASB has initiated a major project on the recognition of revenues that would lead to a new comprehensive accounting standard. The project would (1) eliminate the inconsistencies in the existing authoritative literature and accepted practices, (2) fill the voids that have emerged in revenue recognition guidance in recent years, and (3) provide guidance for addressing issues that arise in the future.

.67 Also, the EITF currently is in the process of addressing four issues related to revenue recognition:

- EITF Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables" EITF Issue No. 00-22, "Accounting for 'Points' and Certain Other Time-Based or Volume-Based Sales Incentive Offers"
- EITF Issue No. 00-24, "Revenue Recognition: Sales Arrangements That Include Specified-Price Trade-In Rights"
- EITF Issue No. 02-G, "Recognition of Revenue from Licensing Arrangements on Intellectual Property"

Auditing Considerations

.68 Given the current economic environment, in which companies are struggling to achieve revenue forecasts, auditors need to conduct adequate and appropriate audit procedures on revenues. Be aware of certain factors or conditions that may indicate increased audit risk of improper, aggressive, or unusual revenue recognition practices. For instance, during 2002, some of the revenue recognition scandals involved the questionable use of sales incentives, the backdating of sales contracts, and the recording of cost overruns on construction projects as revenue before the customer agreed to pay for the overruns.

.69 Management may be aware they are overstating revenue or may simply believe they are reflecting economic substance from their perspective. Be alert for significantly unusual or complex transactions, especially those that occur at or near the end of a reporting period. Revenue recognition principles are sometimes difficult to apply and often vary by industry. A high level of care is always required in this area.

.70 *Extensive Audit Guidance Available.* Chapter 6 of the AICPA Practice Aid, *Fraud Detection in a GAAS Audit—An Auditor's Field Guide*, provides in-depth practical guidance for auditing the risky area of revenue recognition. Moreover, you can turn to the AICPA Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510) for further guidance.

Issuing Stock for Notes Receivable

.71 The accounting improprieties related to a recent business failure included increasing shareholder equity for a note receivable. As a reminder, the generally accepted practice is to offset the notes and stock in the equity section. See EITF Issue No. 85-1, *Classifying Notes Receivable Received for Capital Stock*, for further information.

Accelerating Revenues Through Improper Lease Accounting

.72 Some of the recent instances of inappropriate accounting and earnings management involved a significant case of accelerating revenue through the use of improper accounting for leases by the lessor. Auditors may want to acquaint themselves with the following risks, and understand the accounting requirements of FASB Statement No. 13, as amended.

Manipulation of Sales-Type Lease Components

.73 Management, as a lessor, can accelerate revenues in a sales-type lease by improperly estimating the fair value of the leased asset, and improperly estimating the interest or finance components of the lease. By using these techniques, management can improperly allocate more revenue to the leased asset and recognize that revenue up front when initially recording the lease as opposed to properly reflecting that revenue as part of the interest/finance component of the lease, which would be recognized in the future over the life of the lease. Management may use creative methods in calculating the components of its sales-type leases in an attempt to manage earnings. Auditors should be aware of this possibility and should determine, as appropriate, that management has complied with the requirements of FASB Statement No. 13.

Improper Increases in Residual Values

.74 FASB Statement No. 13 states that an upward adjustment of the estimated residual value in a lease shall not be made. Auditors should be alert to any improper increases in residual values when auditing clients who are lessors. Management may attempt to manage earnings through improper adjustments to the residual values associated with leases of which they are the lessors.

Price Increases and Extensions to Existing Leases

.75 FASB Statement No. 13 requires that additional income realized from the renegotiation of existing leases be recognized over the remaining life of the lease by the lessor. In an attempt to accelerate revenues, management may violate these provisions by recognizing immediately the revenue from price increases and lease extensions. Auditors should be alert to this possibility when auditing clients who are lessors.

Changes to Accounting Principles and Methods

.76 The management of an entity may change their methods of accounting for certain transactions in an attempt to manage earnings or otherwise engineer financial reporting. Auditors should be alert to any changes in accounting principles and methods and determine whether the changes are appropriate and

contribute to the accuracy, quality, and transparency of the financial reporting. Management needs to comply with the requirements of Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, including the requirement to disclose significant changes in accounting principles and methods.

Layoffs—Staff Reductions—Internal Control Risks

.77 Large layoffs, staff reductions, and notifications to employees of impending termination can affect internal control over financial accounting and reporting systems. Key people and key controls may be lost during a downsizing. In addition, remaining employees may feel overwhelmed by their workloads, lack time to complete tasks and consider decisions, and may suffer from low morale. As such, internal control may become less effective or ineffective.

.78 Auditors should be aware of any layoffs or staff reductions occurring on their audit engagements and consider the following:

- Attention to internal control may not have been maintained.
- As a result of unfilled positions, key control procedures may no longer be performed, may be performed less frequently, or may be performed by individuals lacking proper understanding to identify and correct errors.
- Layoffs of information technology personnel may have a negative effect on the entity's ability to initiate, process, or record its transactions, or maintain the integrity of the information generated by the information technology system.
- Key functions that should be segregated may now be performed by one person.
- Changes to the control environment have altered control effectiveness and potentially resulted in a material control weakness.
- Changes in internal control caused by past or pending layoffs or staff reductions may create an opportunity for fraudulent activities.

Special-Purpose Entities

.79 One of the key issues connected to the recent accounting and business scandals is the use of and financial reporting of off-balance-sheet arrangements, specifically special-purpose entities (SPEs). Companies began using SPEs in the late 1980s to conduct financing, access capital, and hedge risk. Today, SPEs are essential components of modern finance and are commonly used to securitize assets such as consumer loans and credit card receivables, facilitate leasing, research and development, and reinsurance. Companies engaged in specialized tasks and large projects that generate significant risks utilize SPEs to isolate financial risk and spread it among other entities. Large construction projects, the purchasing of a fleet of airplanes, and other large-scale undertakings frequently involve SPEs. SPEs are a type of joint venture in which the sponsoring company can spread the enormous debt load required for the undertaking among the various parties to the SPE. Currently, numerous corporations and financial institutions house trillions of dollars of debt in off-balance-sheet entities, like SPEs.

.80 By using SPEs, such as limited partnerships with outside parties, a company is permitted to increase leverage and ROA without having to report debt on its balance sheet. The company contributes hard assets and related debt to an SPE in exchange for an interest. The SPE then borrows large sums of money from a financial institution to purchase assets or conduct other business without the debt or assets showing up on the sponsoring company's financial statements. (For example, a company building a pipeline could create an SPE, in which the SPE owns the pipeline assets and issues debt to finance the project, using the pipeline assets as collateral.) To avoid classification of the SPE as a subsidiary (thereby forcing the sponsoring entity to include the SPE's financial position and results of operations in its financial statements), certain conditions must be met, including that only 3 percent of the SPE be owned by an outside investee. (This requirement will change under a soon-to-be-released FASB Interpretation. See below for further information.)

Many Companies Ultimately Are Responsible for the Losses Incurred by Their Special-Purpose Entities

.81 Financial institutions or other investors are willing to buy bonds issued by SPEs because the debt often possesses a higher rating than normal corporate debt issuances. The higher rating stems from the belief that the SPE's bonds will retain their value because the assets that support them are legally separate from the parent company and are presumed to be of adequate value.

.82 However, if those assets that were transferred to the SPE prove to be less valuable than originally thought, the sponsoring company of the SPE often is required to make up the shortfall. These off-balance-sheet arrangements may result in contractual or other commitments by the sponsoring company, such as requirements to fund losses, provide additional funding, or purchase capital stock or assets, or may otherwise have financial impacts resulting from the performance or nonperformance of the other party. If the SPE falls into financial trouble, the sponsoring company could be faced with a tremendous crisis since it has guaranteed the debt and performance of the SPE (sometimes called credit enhancements). It was these types of triggers that led to a number of recent business failures and scandals.

Misuses of Special-Purpose Entities

.83 Although SPEs and off-balance-sheet arrangements are used to perform legal and necessary business transactions, these financial tools have been misused to deceive shareholders, enrich management of the sponsoring company, conceal troubled assets, hide debt, and keep other pertinent information from investors and interested parties. Other misuses, questionable practices, and risks involving SPEs include:

- Management may attempt to park underperforming assets on the books of an SPE to keep the losses off the company's financial statements.
- An unscrupulous company may sell suspect assets to an SPE at inflated prices and then recognize the proceeds as revenue.
- Management may design an SPE to create the appearance that the SPE's investors and debt holders bear most of the risk of loss, when in fact the sponsoring company retains most or all of the risks.
- In an attempt to ensure the nominal owners of an SPE reach a required percentage of outside equity investment in the SPE, the sponsoring company may use other SPEs it controls to make the necessary equity investments.
- Importantly, a company may fail to provide adequate and clear disclosures about their off-balance-sheet arrangements in the financial statements.

Another major risk, and one that figured prominently in a recent business failure, is the failure of a sponsoring company to consolidate the results of the operations, assets, and liabilities of an SPE when the conditions required for nonconsolidation are not met.

The Market and Washington Respond

.84 Given the prominent place of SPEs in the recent headlines about business failures, investors, politicians, regulators, and other professionals have clamored for a change in the way SPEs are used, accounted for, and reported in financial statements. In particular, attention is focused on (1) bringing these off-balance-sheet transactions back onto a sponsoring company's balance sheet and (2) requiring companies to make full and comprehensive disclosures about their off-balance-sheet activities.

New Accounting Guidance for SPEs

.85 The existing accounting literature related to SPEs is fragmented and incomplete. SPEs engaged in activities other than leasing or securitizations generally are not addressed by existing accounting literature.

In an attempt to clarify, add to, and improve that literature, the FASB has issued an exposure draft of a proposed interpretation of ARB No. 51, *Consolidated Financial Statements*. The title of the proposed Interpretation is *Consolidation of Certain Special Purpose Entities*, and it would apply to public and private companies, but not nonprofit organizations, with an ownership interest in, or a contract or other business relationship with an SPE. The proposal aims not to restrict businesses' use of SPEs but to improve the financial reporting on them.

.86 Current accounting standards require businesses to report, in their consolidated financial statements, on subsidiaries in which they have a controlling financial interest. But ARB No. 51 focuses on parent-subsidiary relationships based on voting ownership interests, which has led businesses to use the existence of such interests as the criterion for determining whether they must report on certain SPEs.

.87 Consolidate If You Are the Primary Beneficiary. There is, however, another way to test for the presence of a controlling financial interest. If a company does not control an SPE through a voting ownership interest, the FASB Interpretation would require it to determine whether it supports the SPE through a variable interest (which may arise from financial instruments, service contracts, nonvoting ownership interests, or other arrangements). If the company holds a majority of such interests in the SPE, that company would be the *primary beneficiary*. The Interpretation would require that enterprise to include in its consolidated financial statements the results of the SPE's activities as well as its assets and liabilities.

.88 The above paragraph addressed situations in which a company does not control an SPE through a voting ownership interest. The proposed Interpretation states that if one or more parties hold equity investments and five specific conditions are met, that would subject an SPE to consolidation based on an evaluation of voting interests as provided in ARB No. 51, instead of by the proposed Interpretation. The absence of any one of those conditions indicates that the nominal owners of an SPE do not control the SPE, and, therefore, the equity investment is a variable interest subject to the provisions of the proposed Interpretation.

.89 Equity Investment Up From 3 Percent to 10 Percent. One of those five conditions is that the amount of the equity investment is sufficient to allow the SPE to finance its activities without relying on financial support from variable interest holders. The proposed Interpretation includes a presumption that an equity investment is insufficient to allow an SPE to finance its activities unless the investment is equal to at least 10 percent of the SPE's total assets. The FASB established that presumption as a benchmark to emphasize that the old requirement for 3 percent equity in EITF Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantee, and Other Provisions in Leasing Transactions*, will be nullified and that an equity investment as small as 3 percent is not likely to be sufficient for most SPEs. The FASB intends that presumption to apply in one direction only; that is, an equity investment of less than 10 percent is presumed to be insufficient, but an equity investment of 10 percent is not presumed to be sufficient.

.90 Disclosure Required. The proposed Interpretation also would require disclosure of information about the assets, liabilities, and activities of consolidated SPEs by the primary beneficiaries and similar information about unconsolidated SPEs by enterprises that act as administrators of those SPEs.

.91 This new guidance aims to ensure that unconsolidated SPEs are truly independent of their sponsoring companies. The FASB believes that the proposed Interpretation would require existing unconsolidated SPEs to be consolidated by primary beneficiaries if they do not effectively disperse risks among parties involved. SPEs that effectively disperse risks would not be consolidated unless a single party holds an interest or combination of interests that effectively recombines risks that were previously dispersed.

.92 Qualifying SPEs. Qualifying special-purpose entities (QSPEs), as described in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and other SPEs with similar characteristics are examples of SPEs that disperse risks. The proposed Interpretation states that

no party would be required to consolidate a QSPE unless a party has rights or obligations or both that would have prevented it from derecognizing the assets had it been the transferor.

.93 *Effect of Proposed Interpretation on EITF Issues.* The proposed Interpretation would nullify the consensuses reached in EITF Issue No. 90-15; EITF Issue No. 96-20, *Impact of FASB Statement No. 125 on Consolidation of Special Purpose Entities*; and EITF Topic No. D-14, *Transactions Involving Special Purpose Entities*. The provisions of the proposed Interpretation would partially nullify the consensuses reached in EITF Issue No. 96-21, *Implementation Issues in Accounting for Leasing Transactions Involving Special Purpose Entities*, and EITF Issue No. 97-1, *Implementation Issues in Accounting for Lease Transactions, including Those Involving Special Purpose Entities*.

.94 *Effective Date.* The proposed Interpretation is expected to be issued by the end of 2002. Its provisions would be applied immediately to SPEs created after the issuance date of the final interpretation. For SPEs created before that date, the provisions of the proposed Interpretation would be applied to those SPEs still existing as of the beginning of the first fiscal year or interim period beginning after June 15, 2003.

Auditing SPEs and Off-Balance-Sheet Arrangements

.95 Auditors should be alert to the existence or creation of SPEs. SPEs may be in the form of corporations, partnerships, limited liability companies, trusts, structured finance entities, or other kinds of agreements, relationships, or understandings. If an SPE has been identified, auditors should ensure that they understand the ownership structure of the entity, all significant terms of the transactions between the entity and the SPE and that management's conclusions regarding nonconsolidation and off-balance-sheet treatment are appropriate under GAAP. Companies may take SPEs to new heights of complexity and sophistication, capitalizing them with not only a variety of hard assets and liabilities, but also extremely complex derivative financial instruments, its own restricted stock, rights to acquire its stock, and related liabilities. As a result of the complexity of these structures and the scrutiny that this area of accounting is currently undergoing, auditors may need to consult with their national office or other technical experts regarding these kinds of structures and related transactions to ensure the appropriateness of accounting and disclosures.

.96 These arrangements may present exposures to the company for which the company's maximum possible liability is not reflected in the financial statements. The exposure can consist of exposures arising from contractual or other commitments as well as economic or legal compulsions to fund losses, provide additional funding, purchase capital stock or assets, or otherwise be financially effected by the performance or nonperformance of the other party.

.97 *Some Incremental Procedures to Perform.* In light of the unique nature of SPEs, the auditor should carefully consider whether transactions entered into with the SPE represent related-party transactions. Incremental procedures, as appropriate, may be necessary to understand the nature of the arrangements and to ascertain whether they represent related-party transactions. This is particularly the case if an entity enters into transactions with SPEs that are outside the company's normal course of business. Incremental procedures that the auditor may wish to consider include:

- Determining whether the issuer of loans or investments held or the primary obligor of debt guarantees issued indicate that an SPE may be involved
- Inquiring as to the nature and terms of any SPE or structured financial arrangements
- Reviewing significant documents and agreements related to significant transactions involving SPEs
- Inquiring about any modifications to existing SPEs that may have been made in the current period that could affect the accounting determined at the date of the transaction

.98 *Making Sure Enough Evidence Is Obtained.* In some circumstances, different auditors may exist for the SPE, or the SPE may not be audited. Situations may also exist in which the auditor is denied access to the

books and records of the SPE because of a lack of an entity interest in the SPE or other legal right to demand such access. Particularly in view of recent events and the risk of material misstatement of the financial statements due to fraud, auditors should consider conducting further procedures with respect to the books and records of the SPE, particularly focusing on whether the requisite outside investment in the SPE existed at the time of the transaction and continues to exist in subsequent periods. If the auditor is not allowed to confirm that GAAP has been followed, either through testing of the SPE's accounting records or through confirmation with other investors, auditors, or other third parties, the auditor should consider whether there is a scope limitation.

.99 If the auditor determines that off-balance-sheet arrangements and transactions represent related-party transactions, the auditor should refer to the related-party standards and guidance (see the topic entitled "Special Advice on Related Parties and Recent Accounting Scandals" of this section). Additionally, the auditor should consider tailoring the management representation letter to include specific representations on critical issues and assumptions related to SPE transactions and confirming that all relevant information and documents have been provided. When warranted, representations should also confirm that no side agreements exist that would materially affect the accounting.

Synthetic Leases

.100 Synthetic lease structures allow a company to treat a business arrangement as an operating lease for financial reporting purposes and yet gain the benefits of deducting interest and depreciation for tax purposes. Differences between the criteria for an operating lease under GAAP and under tax regulations create the opportunity for synthetic leasing to occur. SPEs are normally used to facilitate these transactions. Basically, a company establishes an SPE to own property. That SPE leases the property back to the company that created the SPE. In this manner, a company can gain the benefits of having real estate, without having to report any related assets or liabilities (i.e., heavy mortgage) in its financial statements. And, as stated above, it reaps certain tax benefits.

Accounting for Synthetic Leases

.101 The accounting for synthetic leasing is mainly contained in EITF Issue No. 90-15. Further guidance is contained in EITF Issue No. 96-21, *Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities*; EITF Issue No. 97-1, *Implementation Issues in Accounting for Lease Transactions, Including Those Involving Special-Purpose Entities*; and EITF Issue No. 97-10, *The Effect of Lessee Involvement in Asset Construction*. EITF Issue No. 90-15 lists three conditions that, if met, would require a company to consolidate the lessor SPE. These conditions essentially indicate that the lessee is bearing substantially the risks and returns of the leased property. If the conditions are not met, the company would have a synthetic lease which they would treat as an off-balance-sheet arrangement.

.102 The proposed Interpretation of ARB No. 51, discussed above in the section entitled "Special Purpose Entities," would make it much more difficult for lessees to avoid consolidating the lessor SPE. In many cases, the lessee in the synthetic lease is the primary beneficiary of the lessor SPE. The proposed Interpretation would have the primary beneficiary consolidate the SPE into its financial statements. FASB's proposed Interpretation would nullify some of the EITF Issues listed above and would change the accounting for synthetic leases.

Risks to Watch for

.103 If the economy weakens, synthetic leases may become a trouble spot for entities engaged in such arrangements. Normally, the large amounts of debt that finance the SPE's acquisition of real estate in a synthetic lease becomes due in a short time (three to seven years). In poor economic times, the borrower SPE may run into difficulty refinancing that debt or selling the property. Companies that are the lessees in these arrangements (basically, the company that sponsored the SPE) may be on the hook for guaranteeing the debt or lease obligation.

Tips for Auditors

.104 Auditing advice related to synthetic leases is similar to the guidance presented in the “Special-Purpose Entities” section of this Alert, and you should read that section for auditing information. In some cases, synthetic leases and the related guarantees may be hidden and difficult to identify. Be on the lookout for terms that may point to the existence of a synthetic lease, such as:

- Tax-retention operating leases
- Residual value guarantees
- Restricted cash (meaning that the company may be guaranteeing lease obligations)

FASB Statement No. 142 Accounting Reminder

.105 Auditors should be alert to the proper implementation of FASB Statement No. 142, *Accounting for Goodwill and Intangible Assets*, at their clients. FASB Statement No. 142 requires substantially different accounting for goodwill and intangible assets than was previously required under accounting principles. Ensuring that an entity’s financial reporting properly reflects the requirements of FASB Statement No. 142 will be a challenge for management. These challenges include measuring fair value, determining useful lives, determining amortization methods, estimating residual values, ascertaining reporting units, and performing impairment testing. Auditing goodwill and intangible assets under these new principles may present challenges to auditors. You should be familiar with the accounting requirements of FASB Statement No. 142 and carefully plan the nature, timing, and extent of your audit procedures related to goodwill and intangible assets.

Reminder About Asset Retirement Obligations

.106 FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, changes the measurement approach for asset retirement obligations and is effective for financial statements issued for fiscal years beginning after June 15, 2002. Auditors are reminded that FASB Statement No. 143 differs from previous practice in several significant respects:

- Under FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, and most current practice, an amount for an asset retirement obligation was recognized using a cost-accumulation measurement approach. Under FASB Statement No. 143, the amount initially recognized is measured at fair value.
- Under FASB Statement No. 19 and most current practice, amounts for retirement obligations were not discounted and, therefore, no accretion expense was recorded in subsequent periods. Under FASB Statement No. 143, the liability is discounted and accretion expense is recognized using the credit-adjusted risk-free interest rate in effect when the liability was initially recognized.
- Under FASB Statement No. 19, dismantlement and restoration costs were taken into account in determining amortization and depreciation rates. Consequently, many entities recognized asset retirement obligations as a contra asset. Under FASB Statement No. 143, those obligations are recognized as a liability. Also, under FASB Statement No. 19, the obligation was recognized over the useful life of the related asset. Under FASB Statement No. 143, the obligation is recognized when the liability is incurred.

Some current practice views a retirement obligation as a contingent liability and applies FASB Statement No. 5, *Accounting for Contingencies*, in determining when to recognize a liability. The measurement objective in FASB Statement No. 143 is fair value, which is not compatible with a FASB Statement No. 5 approach. A fair-value measurement accommodates uncertainty in the amount and timing of settlement of the liability, whereas under FASB Statement No. 5, the recognition decision is based on the level of uncertainty.

Declines in the Value of Securities

.107 The declining stock market and uncertain business environment raise issues about the valuation and impairment of securities. Various market indexes have fallen significantly and near-term recovery is uncertain. Securities need to be evaluated to determine whether there has been a decline in value that is other than temporary. FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, establishes accounting standards for both marketable equity and debt securities. Regardless of the valuation method used, GAAP might require recognizing in earnings an impairment loss for a decline in fair value that is other than temporary (note that in the case of trading securities, unrealized holding gains and losses are included in earnings).

.108 Management should determine whether a decline in fair value below amortized cost basis is other than temporary. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security should be written down to fair value as a new cost basis and the amount of the write-down should be included in earnings. The new cost basis shall not be changed for subsequent recoveries in fair value.

Investigating Declines in Value

.109 Management should investigate declines in the value of investments in securities caused by general market conditions or specific information pertaining to an industry or an individual company. Acting upon the premise that a write-down may be required, management should consider all available evidence to evaluate the fair value of its investment. Therefore, in conducting its investigation, management should consider the possibility that each decline may be other than temporary and reach its determination only after consideration of all available evidence relating to the fair value of the security.

.110 *Other than temporary* does not mean permanent. Thus, the point at which management deems the decline to no longer be temporary triggers the obligation to write down the investment. This point may precede a determination that an investment is permanently impaired.

Factors Indicating a Decline Is Other Than Temporary

.111 Judgment is required in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors:

- Fair value is significantly below cost and:
 - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
 - The decline has existed for an extended period of time.
 - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

Determining the Fair Value of a Security

.112 Management's assessment of the fair value of a security should begin with its contemporaneous market price because that price reflects the market's most recent evaluation of the total mix of available

information. Objective evidence is required to support a fair value in excess of a contemporaneous market price. Such information may include:

- The issuer's financial performance including such factors as:
 - Earnings trends
 - Dividend payments
 - Asset quality
 - Specific events
- The near-term prospects of the issuer
- The financial condition and prospects of the issuer's region and industry
- Management's investment intent

Management should employ a systematic methodology that includes the documentation of the factors considered. Such methodology should ensure that all available evidence concerning declines in market values below cost will be identified and evaluated in a disciplined manner by responsible personnel.

Audit Implications

.113 SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides guidance on auditing investments in securities. The companion AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides essential guidance on how to apply SAS No. 92 to your audits. You should familiarize yourself with the guidance in these publications.

.114 The auditor should evaluate (1) whether management has considered relevant information in determining whether factors such as those listed above exist and (2) management's conclusions about the need to recognize an impairment loss. That evaluation requires the auditor to obtain evidence about such factors that tend to corroborate or conflict with management's conclusions. If the entity has recognized an impairment loss, the auditor should gather evidence supporting the amount of the impairment adjustment recorded and determine whether the entity has appropriately followed GAAP.

.115 The auditor is not responsible for designing procedures to detect the presence of these factors per se. Rather, the auditor should consider whether management has considered information that would be relevant in determining whether such factors exist. For example, the auditor would not be responsible for determining whether the financial condition of the issuer of a security has deteriorated, but instead, would ask management how it considered the issuer's financial condition. Once the auditor has determined that the entity considered relevant information, the auditor is responsible for evaluating management's conclusion about the need to recognize an impairment loss. To perform this evaluation, the auditor should gather evidence about factors that tend to corroborate or conflict with management's conclusions.

.116 If the entity has recognized an impairment loss, and the auditor agrees with that conclusion, the auditor should:

- Determine that the write-down of an investment to a new cost basis is accounted for as a realized loss.
- Test the calculation of the loss recorded.
- Determine that the new cost basis of investments previously written down is not changed for subsequent recoveries in fair value.
- Review a summary of investments written down for completeness and unusual items.

- Assess the credit rating of the counterparty.
- Conclude on the adequacy of impairment adjustments recorded.

Round-Trip Transactions

.117 The business community and the accounting profession have been witnessing numerous news stories of late concerning “round-trip” or “wash” transactions. These practices have been connected to the energy-trading and dot-com industries, most recently. The goal of these inappropriate accounting practices is to artificially inflate revenues by creating a circular flow of money that comes back to the company.

.118 Round-trip transactions can take many forms depending upon the industry and the circumstances involved. As an example of how these practices may be conducted in the dot-com sector, an arrangement is put in place by which Company A pays inflated sums to various vendors for services or products; in turn the vendors use these funds to buy online advertising from Company B. Company B then buys online advertising from Company A either on their own behalf or as agents for other advertisers. Company A records the funds it received from Company B as revenue in its financial statements, in violation of GAAP.

.119 In the energy industry, round-trip transactions or wash trades essentially involve passing power back and forth. Companies swap the same amounts of power at the same prices to boost revenue totals.

.120 Auditors should be alert to the possible existence of round-trip trading at their clients and perform audit procedures, as deemed necessary, to identify and test transactions that may point to round-trip accounting. If your client engages in advertising barter transactions, the guidance established in EITF Issue No. 99-17, *Accounting for Advertising Barter Transactions*, should be applied.

Deferring or Eliminating Current Expenses

.121 A major method of managing earnings, and one that has garnered major headlines lately, consists of not recording or deferring current expenses. Questionable or fraudulent accounting practices related to the recognition of expenses is nothing new; however, given the recent rise in reported inquiries and investigations concerning questionable or fraudulent expense recognition practices, auditors should heighten their awareness of this risk and be alert to how management often uses expense accounting to manage earnings. Methods in the news recently include:

- Capitalizing costs that should be expensed
- Inflating the salvage values and useful lives of depreciable assets
- Failing to record accrued expenses
- Failing to write off capitalized costs on projects that are no longer viable (For instance, costs related to the construction of a major asset, which were capitalized, remained as capitalized assets after the construction project was canceled.)
- Reversing the recording of expenses in one period and re-recording them in the next period (Thus, expenses that have been incurred, paid, and recorded in a period are removed from the accounting records and reinstated in the next period, thus violating the matching principle and GAAP.)
- Failing to record adequate asset valuation allowances like inventory shrinkage and doubtful receivable accounts
- Netting expenses with unrelated income
- Improperly classifying expenses on the income statement

Expenditures Related to Existing Assets

.122 Often, one may encounter difficulty in determining whether an expenditure is a capital expenditure or a normal expense. In general, costs incurred that increase the future benefits of an asset or increase its useful life should be capitalized and costs incurred that maintain an existing level of benefit or service should be expensed. Said again, costs that do not increase an asset's future benefits should be expensed.

.123 Ordinary repairs and maintenance expenses should be expensed in the period they are incurred. If the repair is a major repair that will benefit several future periods, consideration should be given to treating the major repair as an improvement. Improvements to and replacements of existing assets may be difficult to differentiate from normal repairs. Judgment must be applied in determining whether the costs incurred actually increase the future service/benefit potential of the asset. If they do, those costs should generally be capitalized.

Disclosure of Factoring Arrangements

.124 Auditors are reminded that factoring arrangements that exist at their clients may need to be disclosed in the financial statements. Factoring arrangements are a means of discounting accounts receivable on a nonrecourse, notification basis. Accounts receivable are sold outright, usually to a transferee (the *factor*) that assumes the full risk of collection, without recourse to the transferor in the event of a loss. Debtors are directed to send payments to the transferee. Factoring arrangements that meet the criteria in paragraph 9 of FASB Statement No. 140, should be accounted for as sales of financial assets because the transferor surrenders control over the receivables to the factor. FASB Statement No. 140 provides guidance on required disclosures.

Cookie-Jar Accounting—Manipulation of Accounting Estimates and Accruals

.125 The increased difficulty in reporting positive or improving financial results during difficult economic times may raise pressure on management to adopt aggressive accounting practices that may improve operating results. Accounting estimates and accruals, by their nature, are easily subject to aggressive accounting practices and therefore are a means to manage earnings. Some of the financial reporting scandals in the news of late involved the use of *cookie-jar* reserves to manage earnings. Simply put, cookie jar accounting consists of overstating accruals, allowances, and other reserves in one period and then reversing them in a subsequent period to boost reported earnings. Auditors may need to pay special attention to this risk on their engagements.

.126 Preparers of financial statements should understand the economic substance of a transaction, and then reflect it properly in the books and records of the company. However, this is not always easy, as accounting rules are not simply black and white, and the nature of transactions is ever more complex.

.127 Changes in estimates may be acceptable when supported by real economic facts, but changing estimates if the underlying economics of the business do not support the change, and without any disclosure, is inappropriate. Auditors may need to review changes in estimates to determine that they are appropriate, timely, and adequately supported with sufficient competent evidential matter. In addition, the company's disclosures need to comply with the requirements of APB Opinion No. 20, *Accounting Changes*, regarding the need to disclose material changes in accounting estimates. Paragraph 33 of APB Opinion No. 20 specifically requires companies to disclose the effect on income and per share amounts for a change that affects several future periods.

.128 Similarly, as required by Item 303 of Regulation S-K, SEC registrants should also disclose in Management's Discussion and Analysis (MD&A) changes in accounting estimates that have a material effect on the financial condition or results of operations of the company, or trends in earnings, or would cause reported financial information to be not necessarily indicative of future operating results or of future financial condition.

SAS No. 57 and Auditing Guidance

.129 Accruals and other estimates are highly subjective and difficult for auditors to verify. When auditing accounting estimates, auditors should give close attention to the underlying assumptions used by management. 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 used in a client's financial statements. The guidelines set by SAS No. 57 include:

- Identifying the circumstances that require accounting estimates
- Considering internal control related to developing accounting estimates
- Evaluating the reasonableness of management's estimate by reviewing and testing the process used and the assumptions made
- Developing an independent expectation about the estimate

As discussed in SAS No. 57, auditors should carefully consider the effects of postbalance-sheet events on the estimation process. Auditors should refer to SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230), which provides guidance on events or transactions that have a material effect on financial statements and that occur subsequent to the balance-sheet date but before the issuance of the financial statements and the auditor's report. Such events or transactions may require adjustment or disclosure in the financial statements.

Evaluating the Support for Management's Assumptions

.130 Management can easily manage and boost earnings by changing the assumptions underlying key accounting estimates. For example, management can change the expected life of some long-term assets to reduce depreciation expense, or management can decide to become more optimistic about when customers will pay their debts and thus reduce bad debt expense on the company's books. When evaluating the support for the assumptions underlying an accounting estimate, you will probably have to rely on evidence that is persuasive, not convincing. Rarely will you be able to obtain enough evidence to be convinced beyond all reasonable doubt.

.131 In order for you to be persuaded, there should be a preponderance of information to support each significant assumption. Preponderance does not mean that a statistical majority of available information points to a specific assumption. Rather a preponderance of information exists when the weight of available information tends to support the assumption.

.132 Remember, as an auditor, you are not trying to conclude that any one given outcome is expected. What you are trying to do is to determine whether certain assumptions are supportable and in turn provide a reasonable basis for the development of the soft accounting information.

.133 When evaluating the support for assumptions you should consider whether:

- Sufficient pertinent sources of information about the assumptions have been considered.
- The assumptions are consistent with the sources from which they were derived.
- The assumptions are consistent with each other.
- The assumptions are consistent with management's plans.
- The information used to develop the assumptions is reliable.
- The logical arguments or theory, considered with the data supporting the assumptions, are reasonable.

.134 Practical guidance on auditing estimates is available in the AICPA Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk). This publication includes information on how

to plan effectively for the audit of soft accounting information, gather and assess relevant audit evidence, and present and disclose proper financial statements. Case examples and information sources necessary to conduct general business and industry research are also included.

Spring-Loading and Premerger Outlays

.135 An entity acquiring another entity may try to worsen the reported financial performance of the purchased company during the period immediately preceding the acquisition date, the *stub period*. By worsening the financial performance of the acquired company before the acquisition, management will find it much easier to report “improved” performance after the acquisition, thus demonstrating the positive effects of the business combination and providing a pop in reported earnings. This practice is often referred to as *spring-loading*. Generally, the practice involves accelerating the purchased company’s payment of payables and other obligations, and writing down investments and other assets on the purchased company’s books. These practices may not necessarily violate the letter of any GAAP standard.

Inappropriately Large Reserves

.136 However, this sort of financial engineering may involve the deliberate inflation of reserves and allowances recorded on the acquired company’s books. These inflated reserves are then reversed in the period following the acquisition providing a generous burst of earnings growth. Accounts that can be manipulated like this include:

- Reserves for merger costs
- Inventory obsolescence allowance
- Pension allowances
- Restructuring reserves
- Reserves for worker’s compensation and medical insurance

Auditors should be on the lookout for these kinds of accounting practices and determine that appropriate GAAP is being followed. Refer to the section of this Alert entitled “Cookie-Jar Reserves” for guidance on accounting for estimates and auditing those amounts.

Overvaluing Equity Investments and the Fair Value of Derivative Instruments

.137 The business and accounting scandals in the news lately revealed accounting improprieties related to investment valuation and derivative instrument valuation. Trouble spots consisted of overvaluing equity investments and overestimating the fair value of derivative contracts; specifically, derivative contracts involved in energy trading. By over-valuing a derivative instrument or an investment, gains result which enhance reported earnings. Auditors should be on the lookout for inflated investment and derivative valuations.

Accounting for Investments in Equity Securities

.138 Generally speaking, FASB Statement No. 115 provides the accounting for investments in equity securities in which the investor holds less than a 20-percent interest in the investee. APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, provides the accounting for investments in which the investor exercises significant influence over the investee (usually 20- to 50-percent ownership interest). When an investor owns over 50 percent of an investee, then consolidation of the investee into the investor’s financial statements is usually required as described in ARB No. 51, as amended by FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*.

Accounting for Derivatives at Fair Value

.139 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, requires all derivatives reported in the statement of financial position to be measured at fair value. The more complex a

derivative, the more difficult it is to determine its fair value. The fair values of derivatives that are exchange-traded are available from independent pricing sources, such as financial publications. The fair values of other derivatives and securities may be available through 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. Valuation risk exists whenever models (as opposed to quoted market prices) are used to determine the fair value of a derivative or security.

Additional Accounting Information on Energy Trading Contracts

.140 EITF Issues No. 98-10, *Accounting for Contracts Involved in Energy Trading and Risk Management Activities*, and No. 00-17, *Measuring the Fair Value of Energy-Related Contracts in Applying Issue No. 98-10*, and EITF Topic No. D-105, *Accounting in Consolidation for Energy Trading Contracts between Affiliated Entities When the Activities of One but Not Both Affiliates Are within the Scope of Issue No. 98-10*, address various aspects of the accounting for contracts involved in energy trading and risk management activities. EITF Issue No. 02-3, *Issues Related to Accounting for Contracts Involved in Energy Trading and Risk Management Activities*, has been developed to codify and reconcile the EITF consensuses on those Issues, and identify other related interpretive issues that have not yet been addressed by the EITF.

.141 At their October 2002 meeting, the EITF reached a consensus to rescind EITF Issue No. 98-10, the impact of which is to preclude mark-to-market accounting for all energy trading contracts not within the scope of FASB Statement No. 133. The EITF also reached a consensus that gains and losses on derivative instruments within the scope of FASB Statement No. 133 should be shown net in the income statement if the derivative instruments are held for trading purposes. The consensuses reached effectively supersede the consensuses reached on EITF Issue No. 02-3 at the June 19-20, 2002, EITF meeting. The consensus regarding the rescission of EITF Issue No. 98-10 is applicable for fiscal periods beginning after December 15, 2002. Energy trading contracts not within the scope of FASB Statement No. 133 purchased after October 25, 2002, but prior to the implementation of the consensus are not permitted to apply mark-to-market accounting.

Auditing Investment and Derivative Valuation

.142 The auditor should obtain evidence supporting management's assertions about the fair value of derivatives and securities measured or disclosed at fair value. The auditor should determine whether GAAP specify the method to be used to determine the fair value of the entity's derivatives and evaluate whether the determination of fair value is consistent with the specified valuation method. GAAP may require that an investment or derivative be valued based on cost, the investee's financial results, or fair value. GAAP may also require disclosures about the value of an investment or derivative. Auditors should follow the guidance in SAS No. 92, as appropriate. Auditors should also read chapter 6 of the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, which contains a wealth of guidance on auditing valuation assertions and other related matters.

Valuation Models Can Be Easy to Tweak

.143 The valuation problems in the news concerned the use of a valuation model and the ease with which it was manipulated by management to bump up the value of investments and derivative contracts, and increase reported income. If the client uses a model to estimate the fair value of an investment or derivative, the auditor may assess the reasonableness and appropriateness of the model by testing the procedures used by management. A valuation model may be easy to adjust in various ways to inflate the reported valuation of an investment or derivative. Consider the following auditing procedures:

1. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.
2. Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests.

3. Consider whether there are additional key factors or alternative assumptions about the factors.
4. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
5. Analyze historical data used in developing the assumptions to assess whether the data are comparable and consistent with data of the period under audit, and consider whether such data are sufficiently reliable for the purpose.
6. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.
7. Review the available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, 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 factors into the accounting estimate.

Exchanges of Nonmonetary Assets

.144 Several recent financial reporting scandals involved the business practices of telecommunications companies “swapping” network capacity. Many of these articles suggest that the companies entering into these transactions may have inappropriately inflated their operating results by recognizing revenue for the network capacity sold, and recording long-term fixed assets for the capacity purchased.

Getting the Accounting Right

.145 In general, APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, requires that the accounting for the exchange of nonmonetary assets be based on the fair value of the asset received or given up, whichever is more reliably determinable. One of the exceptions to this general principle is an asset exchange that does not represent the culmination of the earnings process. For example, an exchange of an asset held for sale in the ordinary course of business (such as inventory) for an asset to be sold in the same line of business. Furthermore, the exchange of a productive asset not held for sale for a similar productive asset also is not viewed as the culmination of the earnings process. These types of nonmonetary exchange transactions are required to be accounted for based upon the recorded amount, or book value, of the asset relinquished.

.146 The simultaneous exchange of nonmonetary assets along with equal amounts of cash consideration between the parties to an exchange would raise significant questions about *substance over form*. If cash consideration is exchanged between the parties to a transaction concurrently with an asset exchange, questions may arise as to the substance or business purpose of the transaction structure, and whether that structure has an economic purpose or is designed solely to remove the transaction from the scope of the accounting literature governing nonmonetary asset exchanges.

.147 In these situations, a careful analysis of the specific facts and circumstances surrounding the transaction would have to be made. To the extent that the “check swapping” between the parties lacks economic substance, such a practice should not alter the accounting for such exchange transactions. In other words, the accounting rules for nonmonetary asset exchanges should be followed.

.148 In addition to APB Opinion No. 29, accounting guidance concerning nonmonetary exchanges is discussed in EITF Issues No. 01-2, *Interpretations of APB Opinion No. 29*; No. 98-3, *Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business*; No. 93-11, *Accounting for Barter Transactions Involving Barter Credits*; No. 99-17, *Accounting for Advertising Barter Transactions*; No. 84-39, *Transfers of Monetary and Nonmonetary Assets among Individuals and Entities under Common Control*; and No. 91-5, *Nonmonetary Exchange of Cost-Method Investments*.

Financial Statement Disclosures

.149 Companies that engage in material nonmonetary transactions during a reporting period are required, under APB Opinion No. 29, to disclose, in the footnotes to the financial statements, the nature of the transactions, the basis of accounting for the assets transferred (that is, fair value or book value), and gains or losses recognized. FASB Statement No. 95, *Statement of Cash Flows*, requires that information about all investing and financing activities of an enterprise that affect recognized assets or liabilities but that do not result in cash receipts or payments, such as nonmonetary asset exchanges, be disclosed in the footnotes to the financial statements.

.150 Furthermore, the SEC's rules require registrants to include in their MD&A, a discussion of the known trends, demands, events, commitments, and uncertainties that are reasonably likely to materially affect a registrant's liquidity, capital resources, and the results of operations. To the extent that nonmonetary exchange transactions have a significant impact on a registrant's liquidity, capital resources, or results of operations, the disclosure of these transactions in MD&A would be required.

Accounting for Telecommunications Capacity Swaps

.151 The expansion of fiber optic communications increased the frequency of transactions involving the "sale" of network capacity. The granting of an indefeasible right to use such network capacity is often referred to as an *IRU*. Pursuant to an *IRU*, an entity purchasing network capacity has the exclusive right to use a specified amount of capacity for a period of time.

.152 As mentioned above, some telecommunications entities swap network capacity. The SEC staff has concluded that all *IRU* capacity swaps consisting of the exchange of leases should be evaluated within paragraph 21 of APB Opinion No. 29. That is, if a swap involves leases that transfer the right to use similar productive assets, the exchange should be treated as the exchange of similar productive assets, irrespective of whether the "outbound" lease is classified as a sales-type lease, direct financing lease, or operating lease and irrespective of whether the "inbound" lease is classified as a capital lease or an operating lease. The SEC staff believes that the lease classification criteria of FASB Statement No. 13, are not an appropriate basis for an entity to "filter" a determination of whether the exchange involves similar productive assets. This conclusion is based on the thought that the right to use an asset, i.e., a lease, is in fact an asset and not a service contract, irrespective of whether such asset is recognized in a company's balance sheet.

.153 This conclusion would require that *IRU* capacity swaps involving the exchange of leases be recognized based on the carrying value of the assets exchanged, rather than at fair value. The SEC staff did point out that exchanges involving sufficient boot would still be treated as part monetary and part nonmonetary as per EITF Issue No. 01-2.

.154 The SEC staff expects that registrants will apply this guidance historically to *IRU* capacity swap transactions that occurred in prior years and, if appropriate, restate their financial statements.

Expensing Stock Options

.155 As a rash of accounting scandals has put the spotlight on companies' financial statements, the accounting treatment of stock options has come under scrutiny. During the second half of 2002, several major U.S. companies have announced their intentions to change their method of accounting for employee stock options to an approach that recognizes an expense for the fair value of the options granted in arriving at reported earnings.

Pros and Cons of Expensing Stock Options

.156 The debate to expense or not to expense stock options rages on. Proponents of expensing stock options argue that stock options represent a large percentage of executive pay. Since all other types of compensation

must be deducted from earnings, they say options should be no exception. Supporters of expensing stock options insist that there has always been a cost for issuing options. When options are exercised, they add to the shares outstanding, in turn driving down earnings per share. To combat this dilutive effect, many companies buy back large number of shares that their executives have exercised. The cash required to buy back these shares is no longer available for use in running and improving the company. Moreover, these companies are not able to use the funds they otherwise would have received by selling those shares in the open market. Therefore, those who support expensing options argue that such costs should be reflected in earnings. Finally, in today's scandalous climate, many more companies are choosing to expense stock options in the hopes of regaining the public's confidence in financial reporting.

.157 But there are many who disagree. Granting options requires no cash outlay, like salaries. Since there is no real cost for companies to deduct, opponents argue that expensing them will unfairly affect earnings. In addition, there is no universal standard for expensing options and all valuation methods require assumptions and estimates. Expensing options could reduce the accuracy of the income statement and leave them open to manipulation. Thus, those who oppose expensing stock options believe that expensing options will undermine the very transparency that the investors are demanding.

FASB Statement No. 123 or APB Opinion No. 25

.158 FASB Statement No. 123, *Accounting for Stock Based Compensation*, defines a fair-value-based method of accounting for employee stock options and encourages all entities to adopt that method of accounting for all of their employee stock option plans. When the Statement was developed in the mid 1990s, it met with significant opposition from the business community. Therefore, while FASB Statement No. 123 provides that expense recognition for the fair value of employee stock options granted is the *preferable* approach, it allows companies to continue to measure compensation cost using the intrinsic value-based method of accounting prescribed by APB Opinion No. 25. Those companies that elect to remain with the accounting in APB Opinion No. 25 must make pro forma disclosures of net income and, if presented, earnings per share, as if the fair-value method of accounting as defined by FASB Statement No. 123 has been used.

.159 Under the fair-value-based method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. Under the intrinsic-value-based method, compensation cost is the excess, if any, of the quoted market price of the stock at grant date over the amount an employee must pay to acquire the stock.

FASB Project to Reconsider Transition and Disclosure Provisions of FASB Statement No. 123

.160 As more and more companies are adopting the preferable approach of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, the FASB has undertaken a limited scope project to reconsider the transition and disclosure provisions of FASB Statement No. 123. This proposal does *not* require companies to adopt the fair-value recognition provisions of FASB Statement No. 123.

.161 The FASB proposal, as it is currently written, would allow those companies who decide to voluntarily adopt the fair-value method to choose from one of three transition methods. Disclosure requirements would be amended also under the proposal to require disclosure of the following information in the accounting policy note of annual and interim financial reports:

- The method of accounting for stock options used in each period presented
- Until such time as stock compensation expense recognized in each period has been measured under the fair-value recognition provisions of FASB Statement No. 123, tabular presentation of:
 - Total stock compensation cost included in net income each period
 - Additional stock compensation cost that would have been included in net income had the fair-value recognition provisions of FASB Statement No. 123 been adopted as of its effective date

- Pro forma net income and earnings per share that would have been reported had fair-value recognition provisions of FASB Statement No. 123 been adopted as of its effective date

The FASB expects to issue an exposure draft of these proposed changes to FASB Statement No. 123 in late 2002.

Potential Future Audit and Business Risks

.162 Auditors should keep alert to the following matters that may be lurking as potential future risks at certain entities.

Off-Balance-Sheet Commitments

.163 Entities, particularly financial institutions, maintain binding commitments to loan substantial sums of money to other parties. These commitments may not be adequately disclosed in the financial statements. If the economy and business environment worsens, and businesses find themselves in trouble and in need of cash, the institutions and other entities that entered into these loan commitments will be forced to send good money after bad, providing significant funds to those troubled businesses. Fulfilling these promises to provide additional funding can be a bad proposition, since collection from a troubled borrower is questionable. One need only look at the examples of Enron and Kmart to understand the risks involved; institutions were required to extend loans to those entities at the very time they were spiraling downward.

.164 Adequate allowances for these commitments may be insufficient or nonexistent. Auditors may need to determine the extent of these commitments at their clients and determine whether they have been properly accounted for, whether any necessary allowance has been established, and whether adequate disclosure of such commitments is made.

Underfunded Pensions

.165 As the stock market has plummeted, so has the value of pension plan assets. Suddenly, entities are faced with the prospect of pouring money into underfunded pension plans. These contributions will reduce earnings, perhaps significantly. In addition, companies with underfunded pension plans face the risk of technically defaulting on the debt they carry. Thus, a going-concern problem can arise. Auditors should be aware of this risk in this current economic environment and determine whether this risk exists at their clients. Audit procedures may need to be designed and performed to address liabilities for underfunded pensions and any going-concern risks. In addition, auditors may need to determine whether disclosure in the financial statements is warranted, based on the pension circumstances at each client.

Unrealistic Pension and Other Postretirement Plan Assumptions

.166 The uncertainty of the current business environment, the falling market values of many investments, and the significant drops in interest rates could contribute to a risk that key assumptions used by management in recording accounting estimates related to their company's pension plan and other postretirement plans may be unrealistic and lead to material misstatement in the financial statements.

.167 Management needs to continually monitor the key assumptions used in measuring pension benefit obligations, returns on plan assets, and periodic service cost. Principal actuarial assumptions include discount rates, participation rates, and factors affecting the amount and timing of future benefit payments. FASB Statements No. 87, *Employers' Accounting for Pensions*, and No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, indicate that each assumption shall reflect the best estimate solely with respect to that individual assumption on the applicable measurement date.

.168 Furthermore, if activity within an existing plan, such as earnings or returns on invested plan assets, has a material impact on the company's liquidity, capital resources, or results of operations, that activity should be discussed in MD&A.

Synthetic Leases

.169 As stated earlier in this Alert, if the economy weakens, synthetic leases may become a trouble spot for entities engaged in such arrangements. Normally, the large amounts of debt that finance the SPE's acquisition of real estate in a synthetic lease becomes due in a short time (three to seven years). In poor economic times, the borrower SPE may run into difficulty refinancing that debt or selling the property. Companies that are the lessees in these arrangements (basically, the company that sponsored the SPE) may be on the hook for guaranteeing the debt or lease obligation. Auditors should read the section above about synthetic leases for further guidance.

Professional Issues

The Sarbanes-Oxley Act of 2002

.170 On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the Act). The Act dramatically affects the accounting profession and affects not just the largest accounting firms, but any CPA actively working as an auditor of or for a publicly traded company or any CPA working in the financial management area of a public company. The Act contains some of the most far-reaching changes that Congress has ever introduced to the business world. Although most of the provisions of this legislation are specific to auditors of public companies, even practitioners not performing audits may be affected by the Act. Therefore, all CPA firms should become familiar with the provisions of the Act.

Timetable

.171 For a timetable of key actions to be taken in response to the Act and for knowledge about what auditors need to know for 2002 audits, 2003, and beyond, go to www.aicpa.org/sarbanes/index.asp.

Major Provisions

.172 Major provisions of the Act include:

- A new Public Company Accounting Oversight Board (PCAOB) of five members has been appointed and is overseen by the SEC. This private-sector regulatory structure will be funded by public companies through mandatory fees.
- Auditors of public companies will be required to register with the board.
- The board has the authority to set and enforce auditing, attestation, ethics, and quality control standards for audits of public companies.
- The Act requires the board to include in auditing standards certain requirements such as:
 - Retention of the audit working papers for a seven-year period
 - A concurring or second partner review of audit reports
 - A description, in the auditor's report of the scope of the auditor's testing of the internal control structure and procedures of the issuer
- Inclusion in the auditor's report or in a separate report of (1) the findings of the auditor's testing of internal controls; (2) an evaluation of (a) whether the internal control structure and procedures include maintenance by the issuer of records that accurately and fairly reflect the transactions and disposition of assets and (b) whether the issuer's internal controls provide reasonable assurance that transactions are recorded in conformity with GAAP, and that receipts and expenditures are being made only in accordance with authorizations of management and directors; (3) a description, at a minimum, of material weaknesses in internal controls.

- The board is empowered to inspect the auditing operations of public accounting firms and to investigate violations of securities laws, standards, competency, and conduct.
- The board can impose disciplinary or remedial sanctions for violations of the board's rules, securities laws related to public company audits, and professional accounting standards. The board will perform annual quality reviews (inspections) for the largest audit firms (more than 100 issuers); smaller firms must be inspected every three years.
- The Act restricts the consulting work auditors may perform for a public company it audits. Banned nonaudit services include bookkeeping, information systems design and implementation, appraisals or valuation services, actuarial services, internal audits, management and human resources services, broker/dealer and investment banking services, legal or expert services unrelated to audit services, and other services the board determines by rule is impermissible. Nonaudit services not banned are allowed if preapproved by the audit committee.
- Audit committees of the company's board of directors are responsible for the hiring, compensation, and oversight of the independent auditor.
- CEOs and CFOs are required to certify company financial statements, with criminal (up to 20 years) and civil (up to \$5 million) penalties for false certification. In the event of a restatement of financial statements arising from securities fraud, CEOs and CFOs must forfeit trading profits and bonuses received prior to the restatement.
- Document altering or destroying in a federal or bankruptcy investigation is now a felony with penalties of up to 20 years. Key audit documents and e-mail must be preserved for five years. It is a felony, with penalties of up to 10 years, to destroy such documents. There is also a provision that requires retention of key audit documents, as defined by the SEC, for seven years.
- The statute of limitations for the discovery of fraud is extended to two years from the date of discovery and five years after the act. (It was previously one year from discovery and three from the act.)

To read a detailed description of the Sarbanes-Oxley Act, go to http://www.aicpa.org/info/sarbanes_oxley_summary.htm.

Ramifications and Rulemaking

.173 The ramifications of some of the provisions in the Sarbanes-Oxley Act will become known only as the SEC and the new PCAOB begin implementing the law. In response to the Act, the SEC has issued a number of rulings, including but not limited to the following:

- The SEC adopted amendments to accelerate the filing deadlines for quarterly reports on Form 10-Q, and annual reports on Form 10-K, required under the Securities Exchange Act. Certain exceptions exist for newer and smaller issuers.
- The SEC adopted rules that require an issuer's principal executive officer and principal financial officer to certify the contents of the issuer's quarterly and annual reports. In addition, officers will need to make representations about the company's disclosure controls and procedures. Changes in internal controls and corrective actions to address significant deficiencies and weaknesses in internal controls are also to be addressed.
- Insider trading reports will need to be filed within two days.

Furthermore, as of the writing of this Alert, the SEC has issued proposed rules regarding improper influence on conduct of audits, code of ethics for senior financial officers, audit committee financial experts, internal control reports, the disclosure of off-balance-sheet activities in MD&A, auditor independence, the retention of audit records, and pro forma financial information. The SEC is expected to also propose rules regarding numerous other provisions of the Act.

Implications for CPAs With Tax Practices

.174 *Expert services* are not defined in the Act and we do not know how broadly the board or the SEC will define this term. It is conceivable that some tax services viewed as traditional may be construed as expert services, and not permitted by any firm providing audit services to publicly held audit clients. In addition, tax services performed by an auditor for a publicly held company would require preapproval by the client's audit committee.

.175 In early December 2002, the SEC proposed rules that address the selling of tax strategies by accounting firms to their audit clients. You can find more information about this recent SEC activity by visiting the SEC web site at www.sec.gov/rules/proposed/33-8154.htm.

Additional Responsibilities for CPAs in Business and Industry

.176 CPAs working in the financial management areas of public companies will be directly affected by the Act. These CPAs need to be aware of the new responsibilities of CEOs and CFOs. They also have a greater duty to communicate and coordinate with corporate audit committees. There are new requirements regarding enhanced financial disclosures as well. CPAs in nonpublic companies should be aware of the possibility that other federal and state regulators may consider adopting similar corporate governance and audit requirements for nonpublic companies.

Loans to Directors and Officers and Insider-Trading Reports

.177 The Act prohibits SEC registrants from making many types of personal loans to their directors and executive officers. In accordance with the Act, corporate insiders of public companies must file reports of transactions in the companies' securities by the second day after the execution of the transaction.

Cascade Effect

.178 Of particular concern is just how far down the Act will cascade, affecting the nation's small and midsized accounting firms of nonpublic companies. A major concern is that the new legislation by Congress may become the template for parallel federal and state legislative or rule changes that directly affect both nonpublic companies that are subject to other regulations and the CPAs that provide services to them.

.179 Section 209 of the Act states:

In supervising nonregistered public accounting firms and their associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable, particularly taking into consideration the size and nature of the business of the accounting firms they supervise and the size and nature of the business of the clients of those firms.

As we write, several states are moving forward with legislation that could result in additional burdens for CPAs and possibly conflict with federal laws. The AICPA and the state CPA societies are monitoring this situation closely and will continue to keep you informed.

Audit Engagement Changes Resulting From Sarbanes-Oxley

.180 Currently, the AICPA ASB is considering the provisions of the Act and its audit implications. Issues being addressed include:

1. A possible amendment to SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), to address the audit working paper retention provisions of the Act
2. Revisiting the attestation standards in light of the Act's provisions regarding internal control reporting

3. Making changes to the quality control standards to respond to the Act's provisions concerning audit partner rotation, concurring review partner reviews, and quality control
4. Looking at communication and reporting needs of audit committees

.181 Internal Control Reports. As mentioned above, the SEC has issued proposed rules that would require a company to file an annual internal control report as part of its annual report. This report would address management's responsibility to establish internal controls and procedures for financial reporting and require management to evaluate the effectiveness of those controls and procedures as of the last day of the company's fiscal year. Under Section 404(b) of the Act, the company's auditor must attest to and report on management's assertions in the internal control report. The company must state this fact and file the auditor's attestation in its annual report.

.182 The ASB has a task force working on providing guidance to auditors for performing this new requirement. It is expected that Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), of the Attestation Standards will serve as a good standard (with some possible modifications) for providing this service. It is also expected that the ASB will enable the auditor to provide, in one report, their opinion on the financial statements and the effectiveness of the internal controls over financial statements.

.183 Quality Control Inspections. The Act, in setting forth quality control requirements, uses the term *internal inspections*. The existing joint quality control task force of the ASB is addressing whether the quality control standards will go back to inspection as an element rather than the current element of monitoring. It is unclear to us why the legislation uses the term *internal inspection* rather than *monitoring*. The current quality control standards recognize that internal inspections are one way to monitor a firm's practice and are used by many firms, including all larger firms. We expect that the quality control standards may be amended to state that firms auditing public companies conduct annual internal inspections as part of their monitoring procedures.

.184 Concurring Partner Review. The new Act requires a concurring partner review. The ASB is currently considering this requirement. It is expected that any guidance will look very similar to the existing SEC Practice Section (SECPs) membership requirement in terms of the concurring reviewer's responsibilities and competencies.

.185 Audit Committees. Section 204 of the Act sets forth certain items that will be required to be reported to the audit committee. It is not clear whether this needs to be a written report or whether oral reports will be acceptable. The ASB has formed a new task force to look at all of the auditor/audit committee aspects of the Act. It is too early to determine the direction of the task force in providing new standards. The task force will need to discuss some of these issues with the board (once it is has been formed) and SEC before making any conclusions. The task force will focus not only on the auditor/audit committee relationship but also how best to communicate with audit committees and how to make certain that audit committees are discharging their responsibilities appropriately.

Your Professional Resource

.186 To help you understand the ramifications of the Sarbanes-Oxley Act and to help you comply with its provisions, the AICPA is developing several resources, including:

1. A new toll-free number is available for any questions your firm or company may have about the legislation, how it will be implemented, and how to comply. The hotline will be staffed Monday through Friday for the remainder of 2002. Call (866) 265-1977, and select the option that is most appropriate for your firm or company. You will receive a response within 24 hours.
2. The AICPA has established the "Sarbanes-Oxley Act Implementation Central" at AICPA Online at www.aicpa.org/sarbanes/index.asp to keep you up-to-date on important developments.

3. Periodic Webcasts will be conducted to brief members on issues as they emerge, as well as short video clips and news alerts that will be sent to members through e-mail.
4. A one-hour CPE training course on the legislation has been developed.
5. Updates and information will be published in numerous newsletters and other communication channels, including AICPA Online, the CPA Letter, and the Journal of Accountancy.

Reaudit Engagements

.187 An auditor may be engaged to reaudit and report on financial statements that have been previously audited and reported on by another auditor (the predecessor auditor). The auditor conducting a reaudit engagement, defined in SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), as the successor auditor but hereinafter referred to as the reauditor, should not place reliance on the work of the predecessor auditor. Even when a reputable firm has already audited the financial statements, the reaudit work performed and the conclusions reached are solely the responsibility of the reauditor. The reauditor should be aware of the audit guidance provided in paragraphs 14 through 20 of SAS No. 84, and in AICPA Practice Alert 02-3, *Reauditing Financial Statements*.

FASB Statement No. 142 Valuation Services

.188 In light of the substantial accounting changes introduced by FASB Statement No. 142, practitioners may become involved in assisting management with determining methodologies for calculating various fair-value measurements, and impairment valuation. Auditors should be aware of and comply with all applicable independence rules (AICPA, SEC, regulatory bodies, etc.) related to the performance of such services.

.189 The AICPA Code of Professional Conduct (Code), states, in Rule 101, *Independence, Interpretation* No. 101-3, "Performance of Other Services" (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05):

A member in public practice or his or her firm ("member") who performs for a client services requiring independence ("attest services") may also perform other nonattest services ("other services") for that client. Before a member performs other services for an attest client, he or she must evaluate the effect of such services on his or her independence. In particular, care should be taken not to perform management functions or make management decisions for the attest client, the responsibility for which remains with the client's board of directors and management.

Interpretation No. 101-3 of the Code goes on to provide much more guidance on this topic. Practitioners should be familiar with these rules. Be aware that an AICPA Ethics task force is currently considering changes to these rules, especially in the areas of bookkeeping, payroll, and business valuation. You can keep abreast of any developments by accessing AICPA Online at www.aicpa.org or by reading various AICPA publications such as the Journal of Accountancy and the CPA Letter.

SEC Guidelines

.190 Under the SEC's current independence rules, an accountant is deemed to lack independence when providing appraisal or valuations services, fairness opinions, or contribution-in-kind reports for audit clients. However, the current rules contain certain exemptions that the SEC is proposing to eliminate in a December 2, 2002, proposed ruling. These proposals would provide that the auditor is not independent if the auditor provides appraisal or valuation services, or contribution-in-kind reports, and there is a reasonable likelihood that the results of the service will be subject to audit procedures by the auditor because the auditor is in a position of auditing his or her own work. Additionally, an auditor is not independent under the proposal if he or she provides a fairness opinion because to do so requires the auditor to function as a part of management and may require the auditor to audit the results of his or her own work.

.191 For further information about the recent SEC proposals, visit the AICPA web site at www.aicpa.org/sarbanes/secproposesrules.asp.

Document Retention Policies

.192 Given the recent obstruction of justice charges leveled against a large accounting firm for destroying documentation related to a client, auditing firms should assess their document retention policies and determine whether they are adequate and formally adopted. SAS No. 96 states that “the auditor should adopt reasonable procedures to retain audit documentation for a period of time sufficient to meet the needs of his or her practice and to satisfy any applicable legal or regulatory requirements for records retention.”

Sarbanes-Oxley Rules and SEC Proposal

.193 Section 802 of the Sarbanes-Oxley Act is intended to address the destruction or fabrication of evidence and the preservation of financial and audit records. In connection with the requirements of section 802, on December 2, 2002, the SEC proposed rules to amend Regulation S-X to require accountants who audit or review an issuer’s financial statements to retain certain records relevant to that audit or review for a period of five years from the end of the fiscal year in which an audit or review was concluded. These records would include working papers and other documents that form the basis of the audit or review, and memoranda, correspondence, communications, other documents, and records (including electronic records), which are created, sent, or received in connection with the audit or review, and contain conclusions, opinions, analyses, or financial data related to the audit or review. Records described in the proposed rules would be retained whether the conclusions, opinions, analyses, or financial data in the records would support or cast doubt on the final conclusions reached by the auditor.

.194 Section 103 of the Sarbanes-Oxley Act directs the PCAOB to require auditors to retain for seven years audit working papers and other materials that support the auditor’s conclusions in any audit report. There may be fewer documents retained pursuant to Section 103, which focuses more on working papers that support the auditor’s conclusions, than under Section 802, which includes not only working papers but also other documents that meet the criteria noted in this release. Many documents, however, may be covered by both retention requirements.

.195 Readers should keep abreast of the status of these proposed rules by visiting AICPA Online at www.aicpa.org/sarbanes/secproposesrules.asp.

Record Retention Policy Advice

.196 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. It is a good practice to document the firm’s retention policy and ensure that the policy is uniformly enforced firm-wide. Once established, the firm should share its record retention policy with its clients. When creating a record retention policy, consider the following:

- State regulations and statutes
- Federal laws and regulations
- Historical information regarding the firm
- Clients’ historical information
- Customer service
- Asset protection
- Risk management
- Disaster planning and vital record protection

.197 Before establishing a record retention policy, it is wise to consult with legal counsel to gain an understanding of any relevant statutes. The policy should be reviewed annually and updated, if necessary, in light of changing government or professional regulations and the cost of retaining records.

.198 When developing your record retention periods, determine whether others are using your work product in neighboring states. Accounting firms that operate in more than one state must comply with the statutes and regulations of all the states in which they are doing business.

Professional Ethics and Independence-Related Developments

.199 This section of the Alert highlights some of the more important developments in the area of professional ethics and independence.

General Accounting Office Issues New Independence Standard

.200 In January 2002 the Government Accounting Office (GAO) amended *Government Auditing Standards* (GAS, also referred to as the Yellow Book), significantly tightening its auditor independence provisions. In issuing the new standard, the comptroller general stated that protecting the public interest and ensuring public confidence in the independence of auditors of government financial statements, programs and operations, both in form and substance, were the overriding considerations. The updated standard is required reading for auditors of government entities and of organizations receiving government funds.

.201 The GAO originally scheduled the new provisions, Amendment No. 3, *Independence*, to take effect October 1, 2002, but many practitioners said certain of the provisions were ambiguous, especially with respect to nonaudit services. AICPA members and others also worried about the cumbersome nature of some of the new standard's independence "safeguards" that, for example, mandated separate engagement teams for audit and nonaudit services.

.202 In response, the GAO helped in two ways. In July, it made the standard effective for all audits pertaining to periods beginning on or after January 1, 2003. At the same time, it issued a series of questions and answers (Q&A) aimed at clarifying the new provisions and facilitating compliance with them. The supplemental guidance explains the standard's underlying concepts, how to make the transition from the old standard to the new and how to apply the standard in specific nonaudit circumstances.

Whom The New Standard Affects

.203 Because government auditing standards apply to a wide variety of entities, the many practitioners who audit their financial statements—CPAs, non-CPAs, government financial auditors and performance auditors—will have to comply with the new standard. Such entities include federal, state, and local governments, as well as not-for-profit and for-profit recipients of federal (and some state) grant and loan assistance, such as:

- Colleges, universities, and trade schools
- Hospitals
- Charitable organizations
- Cities and counties
- School and utility districts
- Small businesses with Small Business Administration loans
- Housing and Urban Development projects and lenders and public housing authorities
- Many state-administered programs and contracts

Understanding What The New Standard Covers

.204 The standard addresses three types of independence impairments, namely, personal, external, and organizational. But it is particularly important that practitioners comprehend the standard's most important change, which involves personal independence impairments such as those discussed below.

.205 *New standard for nonaudit services.* To comply with the provisions governing nonaudit services, auditors must clearly understand two overarching principles. The first bars firms from performing management functions or making management decisions for their clients; the second prohibits auditors from auditing their own work or providing nonaudit services when the services are material or significant to the subject matter of the audit. If a nonaudit service does not conflict with either principle, a firm may perform the service as long as the firm complies with each of a number of safeguards.

.206 *Routine activities.* It is important to note that under the standard, practitioners can perform routine activities for clients without impairing their independence—provided the practitioners neither make management decisions nor perform management functions. Such ordinary services do not violate the overarching principles and are not subject to the safeguards mentioned above. For example, practitioners can participate on a client's committees or task forces *in an advisory capacity*. Auditors can share their skills and knowledge with clients, as long as the clients make all decisions. Practitioners may also give clients routine advice to help:

- Establish internal controls.
- Implement audit recommendations.
- Answer technical questions.
- Provide training.
- Provide tools and methodologies, such as best practice guides, benchmarking studies, and internal-control-assessment methodologies.
- Prepare tax returns.
- Assist with preparing tax deposits.
- Represent audited entities in Internal Revenue Service (IRS) matters.

.207 *Examples of prohibited and permitted nonaudit services.* Both the new standard and subsequent Q&A guidance include specific examples of nonaudit services that are expressly prohibited and others that are permissible (as long as the auditor complies with the two overarching principles and all required safeguards).

.208 *Clarification on providing accounting assistance.* The GAO's Q&A guidance says a practitioner may prepare a trial balance based on management's chart of accounts, as well as draft financial statements and note disclosures as long as the client's management reviews and approves them. This is so because these activities constitute technical assistance and are part of the audit. Therefore, the engagement team that performed these services also could perform the financial statement audit *provided it observes all other safeguards*.

.209 Similarly, the engagement team that converted the client's cash-based financial statements to the accrual basis also could perform the audit because this service is roughly equivalent to proposing adjusting entries to the client's books. In all cases, the standard requires the client's management to specify, in its representation letter, the audit firm's role in providing these services. The letter also must state that management reviews, approves, and is responsible for the services.

.210 In addition, the Q&A guidance describes several types of accounting services, including some that would impair independence and others that would not. The GAO standard permits certain bookkeeping services *if the audit organization does not reconstruct the books and records of the audited entity and management is sufficiently knowledgeable to evaluate, approve, and take responsibility for the services the auditor performs*.

.211 *De minimis exception.* The Q&A guidance provides an exception for nonaudit services that involve a de minimis amount of time. If a firm provides *no more than 40 hours of nonaudit services relating to a specific audit engagement*, the safeguard requiring separate engagement teams is waived. But all other safeguards apply and the nonaudit service still must comply with the overarching principles. When determining the total number of hours they spent on performing nonaudit services, practitioners should include all related services in their calculations.

.212 *Other personal impairments.* Similar to the AICPA, the SEC and the International Federation of Accountants (IFA), the GAO adopted an *engagement-team-focused approach* to auditor independence for matters such as a practitioner's financial interests. The GAO standard requires all individuals participating in the audit engagement, and others within the firm who can directly influence the outcome of the audit, to be free from personal impairments. If the personal impairment affects only an individual on a particular engagement, the audit firm can cure it by requiring the individual to eliminate the impairment. For example, the individual could sell the financial interest that created the independence impairment or remove himself or herself from the audit engagement.

.213 *External and organizational impairments.* The standard lists external factors that may, by interfering with an audit or with a practitioner's ability to form independent and objective opinions and conclusions, constitute an external impairment. This could consist of pressure from management and employees of the audit client or from oversight organizations. For example, interference by management to limit or modify the scope of the audit or pressure to reduce the extent of work performed in order to reduce fees could threaten independence.

.214 The standard also addresses organizational impairments, which, due to the government auditor's place within government and the structure of the government entity the auditor audits, hinder a government audit organization's ability to perform work and report results impartially. The standard specifically describes ways (for example, where the audit organization is assigned to a level of government other than the one to which the audited entity is assigned, such as a federal auditor auditing a state government program) that government audit organizations can be free from organizational impairments when reporting externally to third parties or when reporting internally to management.

Making the Transition to the New Standard

.215 The Q&A guidance clarifies that nonaudit services performed prior to January 25, 2002, in compliance with preexisting professional standards are deemed compliant with the new rules as well. The GAO also will exempt or grandfather from the standard all nonaudit services initiated, agreed to, or performed by June 30, 2002, provided the work is completed no later than June 30, 2003. However, any extensions or change orders to such contracts would result in new contracts, making the overarching principles and safeguards applicable.

Certain Services Can Be Performed as Performance Audits

.216 The GAO realizes firms can perform certain services as either performance audits or consulting engagements. During performance audits—which do not evaluate a business's financial records and statements, but rather assess how a particular activity implements company policy and procedures—a firm would *not* be subject to the independence standard but would have to comply with the performance audit standards under GAAS, including the general, fieldwork, and reporting provisions.

Educational Tools and Links

.217 To help members and others better understand the new standard, the AICPA has developed the following educational tools, which are available on the Institute's Web site (www.aicpa.org/members/div/ethics/index.htm):

- GAO independence standard
- AICPA-GAO comparison of independence rules governing nonaudit services

In addition, the GAO issued a series of questions and answers relating to the standard (www.gao.gov/govaud/d02870g.pdf).

Recent Revisions to AICPA Ethics Interpretations and Rulings

.218 In July 2002, the Professional Ethics Executive Committee (PEEC) revised the following rulings and Interpretations of the AICPA Code of Professional Conduct; see the July 2002 issue of the Journal of Accountancy for the revisions:

- Interpretation No. 101-1, “Interpretation of Rule 101,” of rule 101, subheading titled *Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated With the Client* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02)
- Interpretation No. 101-1, “Interpretation of Rule 101,” of rule 101, subheading titled *Application of the Independence Rules to a Covered Member’s Immediate Family* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02)
- Ethics Ruling No. 10 under rule 203 of the Code, titled “Submission of Financial Statements by a Member in Public Practice”

In November 2002, the PEEC made certain revisions to the following ruling and Interpretation; see the November 2002 issue of the Journal of Accountancy for the revisions:

- Interpretation No. 101-5, “Loans From Financial Institution Clients and Related Terminology,” of rule 101
- Ethics Ruling No. 107 under rule 101 of the Code, titled “Participation in Health and Welfare Plan Sponsored by Client”

SEC Proposes Rules on Auditor Independence

.219 The SEC has proposed rules on auditor independence to implement provisions of the Sarbanes-Oxley Act of 2002. The new independence rules would require certain disclosures and reports by auditors and set conditions under which auditing firms would not be considered independent for purposes of performing audits of public company financial statements. The SEC is proposing rules to:

- Revise its regulations related to the nonaudit services that, if provided to an audit client, would impair an accounting firm’s independence (based on the nine prohibited services listed in Sarbanes-Oxley).
- Require that an issuer’s audit committee preapprove all audit and nonaudit services provided to the issuer by the auditor of an issuer’s financial statements.
- Prohibit partners on the audit engagement team from providing audit services to the issuer for more than five consecutive years and from returning to audit services with the same issuer within five years.
- Prohibit an accounting firm from auditing an audit client’s financial statements if certain members of management of that client had been members of the accounting firm’s audit engagement team within the one-year period preceding the commencement of audit procedures.
- Require that the auditor of an issuer’s financial statements report certain matters to the issuer’s audit committee, including “critical” accounting policies used by the issuer.
- Require disclosures to investors of information related to the audit and nonaudit services provided by, and fees paid by the issuer to, the auditor of the issuer’s financial statements. The disclosures, to be made in issuers’ annual reports, would include fees paid by issuers for audits, tax preparation, and all other fees. The proposal would require disclosure of fees for the year covered by the filing and for the previous year.

In addition, under the proposed rules, an accountant would not be independent from an audit client if any partner, principal, or shareholder of the accounting firm who is a member of the engagement team received compensation based directly on any service provided or sold to that client other than audit, review, and attest services. Readers should keep abreast of these developments by visiting AICPA Online at www.aicpa.org/sarbanes/secproposesrules.asp.

Overview of Foreign Economies

Western Europe

.220 Economic growth throughout much of Europe has been stymied. Although the European economy is starting to show signs of recovery, some experts are predicting a double-dip recession. European equity and debt markets have tumbled, tracking the U.S. markets. Inflation and interest rates are low, however, unemployment remains high, and consumer spending is sluggish.

.221 Germany, Western Europe's largest economy, continues to have economic problems. Both consumer spending and business investment have declined. Experts predict Germany's economy will struggle to grow 1 percent this year. German banks are experiencing difficult times, too. Analysts predict that loan-loss charges could increase by 40 percent. Tens of thousands of German companies are expected to fail in the coming year, so banks are hesitant to make new business loans for fear of not being repaid. Although there is no indication that the large German banks will fail, steps are needed to restructure and improve their performance. This task will be difficult as the poor equity and bond markets gnaw at bank's investment revenues. Inflation has been kept in check because of weak domestic demand and falling oil prices.

.222 The French economy is gathering momentum and is expected to grow 1.5 percent to 2 percent this year. However, the French are plagued by a budget deficit that it has pledged to its fellow euro zone members to eliminate by 2004. Moreover, the French unemployment rate rose by more than expected in June 2002 to 9 percent.

.223 Unfortunately, Europe faced the worst flooding in more than a century during the summer months of 2002. The economic impact of the disaster will affect manufacturing, tourism, and farming. The price tag on the clean-up is expected to top \$10 billion for the German government alone. To pay for the clean-up, the government may postpone a \$7 billion package of tax cuts that were scheduled to take effect on January 1, 2003. Postponing these tax cuts could adversely affect Germany's already sluggish economy. Slovakia; Hungary; and parts of Italy and Britain, the Ukraine, and southern Russia have also been badly hurt by flooding. The total bill for the clean-up could be as much as \$25 billion, making this one of the costliest natural disasters to ever hit Europe.

The Euro

.224 Real euro notes and coins made their debut in 12 European countries on January 1, 2002. Effective March 1, 2002, the national currencies in these 12 countries ceased to be valid. The hope is that the euro and the European economy will create stable money based on a wider economic area. The euro slid against the dollar and hit an all-time low in October 2000 of 82.25 cents. However, the euro rallied in the third quarter of 2002 and became worth scantily more than the U.S. dollar for the first time in more than two years. A stronger Euro helps strengthen the European economy by making it easier for the European central bank to control inflation without raising interest rates.

The Americas

.225 The Latin American economy remains weak largely in part to the continuing decline of the Argentinean economy. Mexico and Chile are, for the most part, insulated from the web of the Latin American decline.

Venezuela

.226 At the end of 2002, Venezuela was suffering economic and political chaos. A general strike, and violent unrest was crippling the country. The U.S. State Department has advised U.S. citizens to avoid traveling to Venezuela.

Argentina

.227 The Argentinian economy remains in recession, and economic indicators are poor. A reduction in the gross domestic product of approximately 16 percent is expected in 2002. Inflation is skyrocketing at about 28.4 percent on an annual basis and it could exceed 100 percent by the end of the year. The Argentinian government is also in flux and cannot provide the leadership to salvage the economy.

Brazil

.228 In the past year, the Brazilian economy has weakened. The Brazilian currency, the real, is declining in value and the country's debt burden is increasing. The International Monetary Fund (IMF) gave Brazil a \$30 billion loan in the third quarter of 2002, in an effort to ease some of the country's economic woes. Although Brazil's government is more stable than neighboring Argentina's, policymakers will have to work hard to ensure a strong and stable economy.

Mexico

.229 Although Mexico may be insulated from economic pressures of Argentina, it mirrors the economic volatility of the United States. The Mexican economy is largely driven by exports to the United States. As the U.S. economy sputters, so too does the Mexican economy. The Mexican Finance Ministry reported in August 2002 that industrial output fell 0.7 percent in June 2002. This is another indicator that recovery in the economy will be slow.

Canada

.230 For the first six months of 2002, the Canadian economy had been strong. In spite of the weak stock market and corporate scandal, the Canadian economy was impressive. The housing market was strong, unemployment was low, and consumer confidence was high. By the third quarter of 2002, the stock market had plunged and the Canadian dollar had weakened. Nevertheless, the Bank of Canada is optimistic about the future of the economy. The central bank expects the economy to grow between 3 and 4 percent for the remainder of 2002. This trend is also expected to continue in 2003. Interest rates, however, are likely to rise because of this economic expansion. Some economists are surprised by this optimistic view in light of global market volatility.

Russia

.231 The upswing in the Russian economy continues. The Russian Trading System Index is up 27 percent in 2002 thus far. Although inflation is at 17 percent, it is considerably lower than the triple digit inflation in the early 1990s. Private investment has been spurred by the passing of the recent legislation that authorizes the private ownership of farmland. Furthermore, the government is considering breaking up the monopolies in natural gas, utilities, railroads, and banks. These moves could provide an influx of both domestic and foreign investment.

Asia

.232 Asia has seen some economic improvement. The Chinese economy continues to grow. The economies of other countries, such as South Korea and Indonesia, whose economies were slumping in the prior year, are now gaining steam. However, the area's future is heavily dependent on the U.S. economy. Exports to America make up 10 percent of Asia's gross domestic product.

Japan

.233 Economic trends in Japan remain grim. In the third quarter of 2002, the Japanese Cabinet Office reported some signs of recovery, but it has forecast flat growth for 2002. Unemployment is 5.2 percent, which is high by Japanese standards. Deflation continues in Japan and domestic demand is weak. Still troubling the Japanese is the bad debt carried by the nation's banks. Bad debts total almost 11 percent of their loan portfolios. Reforms in banking are essential to turning the economy around.

South Korea

.234 The South Korean economy grew 5.7 percent in the first quarter of 2002. They boast of a budget surplus, \$107 billion in foreign currency reserves, and an unemployment rate of 3.1 percent. Although these figures are impressive, signs of the weaknesses in the American and European economies make some experts wonder whether South Korea will be able to maintain this pace of growth.

China

.235 Economic indicators from China continue to be impressive. According to official data, real gross domestic product in the second quarter of 2002 rose 8 percent from a year ago. Growth is expected to continue but not at such a feverish pace. Unemployment persists and many experts contend that the unemployment rate is far higher than the official count. December 2001 marked the entry of China into the World Trade Organization (WTO). The most significant effect of their entry has been deflation as the Chinese have encountered new import competition. Consumer prices fell 0.8 percent in the first half of 2002. This trend is not expected to continue as China's central bank is allowing the money supply to grow.

New Auditing, Attestation, Quality Control Pronouncements, and Other Guidance

.236 Presented below is a list of auditing, attestation, and quality control pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the CPA Letter, Journal of Accountancy, and the quarterly electronic newsletter, In Our Opinion, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 95	<i>Generally Accepted Auditing Standards</i>
SAS No. 96	<i>Audit Documentation</i>
SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i>
SAS No. 100	<i>Interim Financial Information</i>
SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>
SSAE No. 11	<i>Attest Documentation</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i>
SQCS No. 6	<i>Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>
Audit Guide	<i>Service Organizations: Applying SAS No. 70, as Amended</i>

Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i>
Audit Interpretation No. 4 of SAS No. 70	“Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization’s Description of Controls”
Audit Interpretation No. 5 of SAS No. 70	“Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods”
Audit Interpretation No. 14 of SAS No. 58	“Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing”
Audit Interpretation No. 12 of SAS No. 1, section 420	“The Effect on the Auditor’s Report of an Entity’s Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Change in the Year of Adoption”
Auditing Interpretation No. 15 of SAS No. 58	“Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations”
Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Practice Alert 02-1	<i>Communications With the Securities and Exchange Commission</i>
Practice Alert 02-2	<i>Use of Specialists</i>
Practice Alert 02-3	<i>Reauditing Financial Statements</i>
Practice Aid	<i>Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide</i>
Practice Aid	<i>New Standards, New Services: Implementing the Attestation Standards</i>
Practice Aid	<i>Assessing the Effect on a Firm’s System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor’s Report: A Guide for Financial Statement Users</i>

.237 The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 95, *Generally Accepted Auditing Standards*

.238 In December 2001, the ASB issued SAS No. 95, *Generally Accepted Auditing Standards*, which supersedes section 150, *Generally Accepted Auditing Standards*, of SAS No. 1. SAS No. 95 establishes a hierarchy of GAAS consisting of auditing standards, interpretive publications, and Other Auditing Publications. SAS No. 95 is effective for audits of financial statements for periods beginning on or after December 15, 2001.

SAS No. 96, *Audit Documentation*

.239 In January 2002, the ASB issued SAS No. 96. SAS No. 96 (AICPA, *Professional Standards*, vol. 1, AU sec. 339) supersedes SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339A), and amends SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312); SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329); and SAS No. 59. SAS No. 96 is effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted.

.240 Among other things, SAS No. 96:

- Lists factors that the auditor should consider in determining the nature and extent of the audit documentation to be prepared for a particular audit area or auditing procedure.
- Requires audit documentation to include abstracts or copies of significant contracts or agreements examined and, for tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation, requires audit documentation to include an identification of the items tested.
- Requires documentation of audit findings or issues that in the auditor's judgment are significant, actions taken to address them (including any additional evidence obtained), and the basis for the final conclusions reached. (SAS No. 96 includes a list of types of significant audit findings and issues.)
- Requires the auditor to adopt reasonable procedures to prevent unauthorized access to the audit documentation.

SAS No. 97, *Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles*

.241 This amendment, SAS No. 97, *Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 625), revises SAS No. 50, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 625), to prohibit an accountant from providing a written report on the application of accounting principles not involving facts and circumstances of a specific entity.

.242 This Statement is effective for written reports issued or oral advice provided on or after June 30, 2002. Earlier application of the provisions of this Statement is permissible.

SAS No. 98, *Omnibus Statement on Auditing Standards—2002*

.243 In September 2002, the ASB issued SAS No. 98, *Omnibus Statement on Auditing Standards—2002*, which makes various amendments to existing SASs, including SAS No. 95; SAS No. 25, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 161.02 and .03); SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*; SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324); SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.65); SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*; SAS No. 52, *Required Supplementary Information*; and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*

.244 SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), supersedes SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316A), amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230). The Statement does not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02). However, SAS No. 99 establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.

.245 The following is an overview of the content of SAS No. 99:

- *Description and characteristics of fraud.*
- *The importance of exercising professional skepticism.* This section discusses the need for auditors to exercise professional skepticism when considering the possibility that a material misstatement due to fraud could be present.

- *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.* This section requires, as part of planning the audit, that there be a discussion among the audit team members to (1) consider how and where the entity's financial statements might be susceptible to material misstatement due to fraud and (2) reinforce the importance of adopting an appropriate mindset of professional skepticism.
- *Obtaining the information needed to identify the risks of material misstatement due to fraud.* This section requires the auditor to gather the information necessary to identify the risks of material misstatement due to fraud, by:
 1. Inquiries of management and others within the entity about the risks of fraud
 2. Considering the results of the analytical procedures performed in planning the audit
 3. Considering fraud risk factors
 4. Considering certain other information
- *Identifying risks that may result in a material misstatement due to fraud.* This section requires the auditor to use the information gathered above to identify risks that may result in a material misstatement due to fraud.
- *Assessing the identified risks after taking into account an evaluation of the entity's programs and controls.* This section requires the auditor to evaluate the entity's programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation.
- *Responding to the results of the assessment.* This section emphasizes that the auditor's response to the risk of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence. The section requires the auditor to respond to the results of the risk assessment in three ways:
 1. A response that has an overall effect on how the audit is conducted, that is, a response involving more general considerations apart from the specific procedures otherwise planned
 2. A response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed
 3. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls
- *Evaluating audit evidence.* This section requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate, at the completion of the audit, whether the accumulated results of auditing procedures and other observations affect the assessment. It also requires the auditor to consider whether identified misstatements may be indicative of fraud and, if so, directs the auditor to evaluate their implications.
- *Communicating about fraud to management, the audit committee, and others.* This section provides guidance regarding the auditor's communications about fraud to management, the audit committee, and others.
- *Documenting the auditor's consideration of fraud.* This section describes related documentation requirements.

In addition, SAS No. 99 includes an amendment to SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333.06 and Appendix A), since SAS No. 99 requires the auditor to make inquiries of management about fraud and risk of fraud. In support of and consistent with these inquiries, the amendment revises the guidance for management representations about fraud currently found in SAS No. 85, paragraph 6*h* and Appendix A.

.246 SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.

Implementation Guide Available

.247 The AICPA will issue in December 2002 a Practice Aid, *Fraud Detection in a GAAS Audit*—SAS No. 99 *Implementation Guide*, to help implement SAS No. 99. See below for further information.

SAS No. 100, *Interim Financial Information*

.248 The ASB has voted to issue SAS No. 100, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), which replaces SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722A), as amended. The revised SAS will provide additional guidance on performing reviews of interim financial information and incorporate the requirement of the SEC for timely filings of interim financial information. The standard is applicable to an accountant performing a review of interim financial information of:

- An SEC registrant
- A non-SEC registrant that makes a filing with a regulatory agency in preparation for a public offering or listing, if the entity's latest annual financial statements have been or are being audited.

The SAS is effective for interim periods within fiscal years beginning after December 15, 2002. Earlier application of the provisions of the Statement is permitted.

SQCS No. 6, *Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice*

.249 In September 2002, the ASB issued Statement on Quality Control Standards (SQCS) No. 6, *Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards*, vol. 2, QC sec. 20). SQCS No. 6 clarifies that deficiencies in individual audit, attest, compilation, and review engagements do not, in and of themselves, indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards. This amendment is effective upon issuance.

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

.250 In May 2002, the ASB issued this SOP, which was developed to provide practitioners with guidance on performing agreed-upon procedures engagements that address annual claims prompt payment reports as required by the New Jersey Administrative Code. Practitioners should note that the engagement described in this SOP is designed only to satisfy the requirements of the Code. The procedures, as set forth in this SOP, are not necessarily appropriate for use in any other engagement.

SSAE No. 11, *Attest Documentation*

.251 This amendment to SSAE No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT secs. 101.100–[.108], 201[.27–.30], and 301[.32]), reflects the concepts and terminology used in SAS No. 96, *Audit Documentation*.

.252 SSAE No. 11 is effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002. Earlier application is permitted.

SSAE No. 12, *Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification*

.253 This Amendment to SSAE No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101.17–.18), clarifies the relationship between the SQCSs and engagements

performed under the SSAEs. The amendment clarifies that although an effective quality control system is conducive to compliance with attestation standards, deficiencies in or noncompliance with a firm's quality control system do not, in and of themselves, indicate that an engagement was not performed in accordance with the applicable professional standards. This amendment is effective upon issuance.

Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*

.254 This Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772kk) provides guidance to service auditors engaged to issue reports on a service organization's controls that may be part of a user organization's information system in the context of an audit of financial statements. It also provides guidance to user auditors engaged to audit the financial statements of entities that use service organizations. Guidance on performing service auditors' engagements and using service auditors' reports in audits of financial statements is provided in SAS No. 70, *Service Organizations*.

Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*

.255 This new Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)* (product no. 012662kk) addresses the audits of basic financial statements and consideration of required supplementary information (RSI) and supplementary information (SI) other than RSI prepared in conformity with the new governmental financial reporting model required by Government Accounting Standards Board (GASB) Statement No. 34, and its related pronouncements.

.256 The new Guide is to be effective for audits of a state or local government's financial statements for the first fiscal period ending after June 15, 2003, in which the government does apply or is required to apply the provisions of GASB Statements No. 34 or No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. Earlier application will be encouraged if a government issues financial statements that apply GASB Statements No. 34 or No. 35 after the Guide is issued. The AICPA's 1994 Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)* (updated annually for conforming changes) will remain effective for audits of state and local governments for which the auditor is not required to apply or has not elected to early apply the provisions of the new Guide in accordance with its effective date provisions.

.257 The new Guide, like the previous guide, applies to *all* state and local governmental entities. That scope requires an auditor to consult two guides when performing audits of governmental entities in certain industries. Specifically, the new Guide applies to public entity risk pools and hospitals and other health care providers, even though the audits of those entities also are subject to the guidance in the Audit and Accounting Guides *Audits of Property and Liability Insurance Companies* and *Health Care Organizations*, respectively. The new Guide explains how auditors of those entities should use the auditing guidance in both of the guides that apply to those entities. The new Guide also provides an expanded section on auditing public colleges and universities.

Auditing Interpretations

.258 In February 2002, the ASB issued two interpretations of SAS No. 70, *Service Organizations*:

- Interpretation No. 4, "Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls," of SAS No. 70 (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.35–.37)
- Interpretation No. 5, "Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods," of SAS No. 70 (AICPA, *Professional Standards*, vol. 1, AU sec. 9324.38–.40)

.259 In March 2002, the ASB issued Interpretation No. 14, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With

International Standards on Auditing,” of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.56–.59), which provides guidance to the auditor that SAS No. 58 does not prohibit the auditor from indicating in the auditor’s report that the audit was also conducted in accordance with another set of auditing standards.

.260 In April 2002, the ASB issued Interpretation No. 12, “The Effect on the Auditor’s Report of an Entity’s Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Changes in the Year of Adoption,” of SAS No. 1, section 420, “Consistency of Application of Generally Accepted Accounting Principles” (AICPA, *Professional Standards*, vol. 1, AU sec. 9420.69–.72), which provides guidance to the auditor in determining materiality for purposes of applying the consistency standard when an accounting standard does require the entity to disclose, and the entity has not disclosed or determined, the effect of the change in accounting principle in the year of adoption.

.261 In November 2002, the ASB issued Interpretation No. 15, “Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations” of SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.60–.75).

Related-Party Toolkit

.262 The AICPA staff has developed an electronic document, *Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors*, to provide accountants and auditors of private-sector business enterprises with an overview of selected authoritative accounting and auditing literature, SEC requirements, and nonauthoritative best practice guidance concerning related parties and related-party transactions. The related-party toolkit is available on the AICPA Web site at www.aicpa.org/public/download/news/relpty_toolkit.doc.

Practice Alert 02-1, *Communications With the Securities and Exchange Commission*

.263 The AICPA Securities and Exchange Commission Practice Section (SECPS) Executive Committee established a Professional Issues Task Force (PITF) which formulates guidance based on issues arising in peer reviews, firm inspections, and litigation to facilitate the resolution of emerging audit practice issues. This guidance takes the form of Practice Alerts. The information contained in these Practice Alerts is nonauthoritative. It represents the views of the members of the PITF and does not represent official positions of the AICPA.

.264 Practice Alert 02-1, *Communications With the Securities and Exchange Commission*, provides registrants and their auditors with the most up-to-date information about when, why, and how they may wish to discuss SEC accounting, financial reporting and disclosure issues and questions with the staff at the SEC. In addition, this Alert is intended to provide professionals with references to other resources that may be useful when working with SEC registrants.

Practice Alert 02-2, *Use of Specialists*

.265 Auditors may encounter difficulty in determining the appropriate situations in which to utilize a specialist and, in those cases in which a specialist is appropriately utilized, understanding the findings of the specialist. The purpose of Practice Alert 02-2, *Use of Specialists*, is to assist auditors in understanding their responsibilities both with respect to the use of specialists that have been engaged or employed by the audit client and the use of specialists engaged or employed by the audit firm.

Practice Alert 02-3, *Reauditing Financial Statements*

.266 An auditor may be engaged to reaudit and report on financial statements that have been previously audited and reported on by another auditor (the predecessor auditor). The purpose of Practice Alert 02-3,

Reauditing Financial Statements, is to provide practitioners with additional factors to consider when performing a reaudit engagement.

Practice Aid, *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*

.267 In connection with the issuance of SAS No. 99, the AICPA has developed a practice aid to help practitioners implement the new fraud guidance. The practice aid is entitled *Fraud Detection in a GAAS Audit—An Auditor's Field Guide* (product no. 006613) and will be available in December 2002. The Practice Aid includes topics such as:

- How the new SAS changes audit practice
- Developing an implementation plan
- Audit issues in revenue recognition
- Inquiries of entity personnel
- Practice aids such as:
 - Specialized industry fraud risk factors
 - Common frauds and extended audit procedures

Practice Aid, *New Standards, New Services: Implementing the Attestation Standards*

.268 Issued in January 2002, the Practice Aid, *New Standards, New Services: Implementing the Attestation Standards* (product no. 006601), helps practitioners understand and implement the major provisions of the attestation standards. Essential guidance contained in the publication includes pre-engagement considerations, gathering evidential matter, the attestation risk model, types and extent of procedures, and reporting considerations.

Practice Aid, *Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel*

.269 In a move to ensure that even greater attention is paid to audit firm quality control systems, the SEC Practice Section of the AICPA issued guidance entitled, *Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel*, for U.S. audit firms. The special guidance is directed toward audit firms taking on increased numbers of new publicly traded clients and/or professional staff. The practice aid is available on the AICPA's website at http://www.aicpa.org/download/secps/020508_practaid.pdf.

Booklet, *Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users*

.270 The AICPA has published a booklet (product no. 058516) titled, *Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users*, that explains the meaning of the auditor's report on financial statements and the assurance it provides. The booklet is particularly useful to existing and potential audit clients, investors, creditors, and, students who need to understand audit reports.

New Accounting Pronouncements and Other Guidance

.271 Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the CPA Letter and Journal of Accountancy.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated with Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions</i>
FASB Interpretation No. 45	<i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i>
SOP 01-5	<i>Amendment to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</i>
SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i>
Technical Practice Aids	<i>Software Revenue Recognition</i>
Questions & Answers	<i>FASB Statement No. 87, Employers' Accounting for Pensions</i>

.272 The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org.

FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*

.273 The FASB issued its Statement No. 145 in April 2002 which rescinds FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, and an amendment of that Statement, FASB Statement No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements*, thereby eliminating the requirement that gains and losses from debt extinguishments be classified as extraordinary items. Instead, those entities should use the provisions of APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, as amended and interpreted, to report debt extinguishments in fiscal years beginning after May 15, 2002, with earlier application encouraged. Other effective dates apply to the other provisions of FASB Statement No. 145. This Statement also rescinds FASB Statement No. 44, *Accounting for Intangible Assets of Motor Carriers*. This Statement amends FASB Statement No. 13, as well, to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. This Statement also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changed conditions. Refer to the Statement for effective date information.

FASB Statement No. 146, *Accounting for Costs Associated With Exit or Disposal Activities*

.274 This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)."

.275 This Statement requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. The board concluded in this Statement that an entity's commitment to a plan, by itself, does not create a present obligation to others that meets the definition of a liability. Therefore, this Statement eliminates the definition and requirements for recognition of exit costs in EITF Issue No. 94-3. This Statement also establishes that fair value is the objective for initial measurement of the liability. Refer to the Statement for effective date and transition information.

FASB Statement No. 147, *Acquisitions of Certain Financial Institutions*

.276 FASB Statement No. 147, *Acquisitions of Certain Financial Institutions*, addresses guidance on accounting for the acquisition of a financial institution and applies to all acquisitions except those between two or more mutual enterprises (the combination of which is currently being discussed as a separate board topic this year.) See the AICPA Audit Risk Alert, *Banks, Credit Unions, and Other Lenders and Depository Institutions—2002/03* [AAM section 8010], for further information.

FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*

.277 This Interpretation elaborates on the existing disclosure requirements for most guarantees, including loan guarantees such as standby letters of credit. It also clarifies that at the time a company issues a guarantee, the company must recognize an initial liability for the fair value, or market value, of the obligations it assumes under that guarantee and must disclose that information in its interim and annual financial statements. Before this Interpretation was issued, many entities did not recognize a liability for a guarantee until honoring the guarantee became likely.

.278 This guidance does not apply to certain guarantee contracts, such as those issued by insurance companies or for a lessee's residual value guarantee embedded in a capital lease. The provisions related to recognizing a liability at inception of the guarantee for the fair value of the guarantor's obligations would not apply to product warranties or to guarantees accounted for as derivatives.

.279 The initial recognition and initial measurement provisions apply on a prospective basis to guarantees issued or modified after December 31, 2002, regardless of the guarantor's fiscal year-end. The disclosure requirements in the Interpretation are effective for financial statements of interim or annual periods ending after December 15, 2002.

SOP 01-5, *Amendment to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*

.280 This AICPA Statement of Position (SOP) amends AICPA SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, as a result of the completion of the National Association of Insurance Commissioners (NAIC) Codification of statutory accounting practices for certain insurance enterprises.

.281 This SOP also includes auditing guidance that has been updated as a result of the completion of the NAIC Codification, namely, AICPA SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*; SOP 94-1, *Inquiries of State Insurance Regulators*; and AICPA Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Information Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.77).

.282 This SOP is effective for annual financial statements for fiscal years ending on or after December 31, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements.

SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*

.283 This SOP applies to any entity that lends to or finances the activities of others. For example, that arrangement may be a secured mortgage loan, an unsecured commercial loan or a financing arrangement that only involves extending credit to trade customers resulting in trade receivables. Those financing activities of all entities are included in the scope of this SOP. The SOP provides specific guidance for other types of transactions, such as securities purchases, for certain financial institutions listed in the scope

paragraphs of the SOP. To the extent an entity is not considered such a financial institution, as described in those paragraphs, the other guidance provided is not applicable. In other words, only the guidance in this SOP related to the financial and lending activities is applicable for entities not considered to be financial institutions.

.284 SOP 01-6 reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by the AICPA Audit and Accounting Guides *Banks and Savings Institutions*, *Audits of Credit Unions*, and *Audits of Finance Companies*. The SOP also explicitly incorporates mortgage companies, corporate credit unions, and certain activities of insurance companies in its scope. This SOP will be incorporated in a new AICPA Audit and Accounting Guide, which will supersede the three aforementioned Guides. The new Guide is expected to be issued during the first quarter of 2003. See the SOP for effective date and transition information.

Software Revenue Recognition Technical Practice Aids Issued

.285 The AICPA staff, helped by industry experts, released a fifth set of technical questions and answers (Q&As) on financial accounting and reporting issues related to SOP 97-2, *Software Revenue Recognition*. Q&As will be housed in the AICPA publication titled *Technical Practice Aids*, copies of which are available through the AICPA order department at (888) 777-7077 or online at CPA2BIZ.com.

New FASB Statement No. 87 Q&A—*Impact of the Sunset Provision of the Economic Growth and Tax Relief Reconciliation Act*

.286 FASB staff members issued implementation guidance (www.fasb.org/q&a87.pdf) on FASB Statement No. 87, *Employers' Accounting for Pensions*. The advisory addresses the anticipated impact of the expiration of the Economic Growth and Tax Relief Reconciliation Act after 2010 on the temporary exceptions the legislation permitted to IRC section 415(b) limits on the amount of payments a qualified defined benefit plan could make to its participants.

On the Horizon

.287 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that may be relevant to your engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.288 The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed below. Readers should refer to information provided by the various standard-setting bodies for further information.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/auditstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

.289 The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Auditing Pipeline

Exposure Draft on Auditing Fair Value Measurements and Disclosures

.290 The AICPA's ASB has issued an exposure draft of a proposed SAS entitled *Auditing Fair Value Measurements and Disclosures*. The proposed SAS addresses auditing considerations relating to the measurement, presentation, and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. The ASB will discuss a revised draft of the proposed SAS at its December 2002 meeting. If approved at that meeting, the SAS will be issued by February 2002.

New Framework for the Audit Process

.291 The ASB has voted to expose a suite of seven proposed SASs relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance the auditor's application of the audit risk model in practice by requiring:

- A more in-depth understanding of the entity and its environment, including its internal control, that would better enable the auditor to identify the risks of material misstatement in the financial statements and any steps the entity is taking to mitigate them
- A more rigorous assessment of the risks of material misstatement of the financial statements based on that understanding
- A better linkage between the assessed risks of material misstatement and the nature, timing, and extent of audit procedures performed in response to those risks

.292 The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*
- *Audit Evidence*, which will supersede SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)
- *Audit Risk and Materiality in Conducting an Audit*, which will supersede SAS No. 47
- *Planning and Supervision*, which will supersede SAS No. 1, section 310, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 310), and SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Assessing Risks)
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, which will supersede SAS No. 45, and, together with the proposed SAS, *Assessing Risks*, will supersede SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319)
- *Amendment to SAS No. 39, Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350)

You should keep abreast of the status of these projects and exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Accounting Pipeline

Consolidation of Certain Special-Purpose Entities

.293 The FASB has issued an exposure draft of a proposed Interpretation of ARB No. 51, *Consolidation of Certain Special-Purpose Entities*. This proposed Interpretation would address consolidation by business enterprises of SPEs to which the usual condition of consolidation described in ARB No. 51, *Consolidated Financial Statements*, does not apply because the SPEs have no voting interest or otherwise are not subject to control through ownership of voting interests. A final Statement is expected to be issued during the fourth quarter of 2002.

Amendment of Statement 133 on Derivative Instruments and Hedging Activities

.294 The FASB has issued an exposure draft of a proposed Statement, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. This proposed Statement would amend the definition of a derivative in paragraph 6(b) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This proposed Statement also would amend Statement 133 for various decisions made as part of the Derivatives Implementation Group process. A final Statement is expected to be issued during the fourth quarter of 2002.

Exposure Draft on Liabilities and Equity

.295 The FASB has issued an exposure draft of a proposed Statement, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*. This proposed Statement would establish standards for issuers' classification in the statement of financial position of financial instruments with characteristics of liabilities, equity, or both. The FASB also issued an exposure draft of a proposed amendment to FASB Concepts Statement No. 6 entitled *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*. This proposed amendment would revise the definition of liabilities to also include as liabilities certain obligations that require or permit settlement by issuance of the issuer's equity shares and that do not establish an ownership relationship. Final Statements are expected to be issued during the fourth quarter of 2002.

Exposure Draft on Loans and Certain Debt Securities Acquired in a Transfer (Formerly Known as Purchased Loans and Securities)

.296 AcSEC has issued an exposure draft of a proposed SOP titled *Accounting for Loans and Certain Debt Securities Acquired in a Transfer*. This proposed SOP considers whether Practice Bulletin (PB) No. 6, *Amortization of Discounts on Certain Acquired Loans*, continues to be relevant given a number of FASB pronouncements issued subsequent to PB No. 6. The proposed SOP excludes originated loans from its scope. Readers should be alert to any final pronouncement.

Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment

.297 Proposed AICPA SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, and proposed FASB Statement, *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment—an amendment of APB Opinions No. 20 and 28 and FASB Statements No. 51 and 67 and a rescission of FASB Statement No. 73*, were issued simultaneously for public comment. Principally, the proposed FASB Statement would amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from its scope the accounting for acquisition, development, and construction costs of real estate developed and used by an entity for subsequent rental activities. The accounting for those costs would be subject to the guidance in the proposed SOP. It also would amend APB Opinion No. 28, *Interim Financial Reporting*, to require that those costs that the proposed SOP would require be expensed as incurred on an annual basis also be expensed as incurred in interim periods.

.298 The proposed SOP addresses accounting and disclosure issues related to determining which costs related to property, plant, and equipment should be capitalized as improvements and which should be charged to expense. The proposed SOP also addresses capitalization of indirect and overhead costs and component accounting for property, plant, and equipment. Final Statements are expected to be issued during the first half of 2003.

Resource Central

Educational courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

.299 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- Audit Guide *Auditing Derivative Instruments, Hedging Activities and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit and Accounting Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012551kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2002*
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Fraud Detection in a GAAS Audit* (product no. 006613kk)
- Audit Risk Alert *E-Business Industry Developments—2002/03* [AAM section 8210]

Audit and Accounting Manual

.300 The *Audit and Accounting Manual* (product no. 005131kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditor's reports; checklists; engagement letters, and management representation letters, and confirmation letters.

AICPA's reSOURCE Online Accounting and Auditing Literature

.301 Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, *Audit and Accounting Guides* (all 23), *Audit Risk Alerts* (all 19), and *Accounting Trends & Techniques*. To subscribe to this essential service, go to cpa2biz.com.

reSOURCE CD-ROM

.302 The AICPA is currently offering a CD-ROM product entitled *reSOURCE: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access to AICPA Professional Literature products in a Windows format, namely, *Professional Standards*, *Technical Practice Aids*, and *Audit and Accounting Guides* (available for purchase as a set that includes all Guides and the related Audit 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.

Online CPE

.303 The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee (\$95 for members and \$295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

Member Satisfaction Center

.304 To order AICPA products, receive information about AICPA activities, and find help on your membership questions call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.305 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.306 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.

Web Sites

AICPA Online and CPA2BIZ

.307 AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, CPA2BIZ.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the professional standards, and CPE courses.

Other Helpful Web Sites

.308 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of the Alert.

.309 This Audit Risk Alert replaces the AICPA *Audit Risk Alert—2001/02*. The general *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 those with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to rdurak@aicpa.org, or write to:

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Jersey City, NJ 07311-3881

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Information Sources

Organization	General Information	Fax Services	Internet	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	www.aicpa.org	<i>AcSEC Telephone Line</i> (212) 596-6008
Financial Accounting Standards Board	<i>Order Department</i> P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	<i>Action Alert Telephone Line</i> (203) 847-0700 (ext. 444)
U.S. General Accounting Office	<i>Superintendent of Documents</i> U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800	<i>Information Line</i> (202) 512-2250	www.gpo.gov	
Securities and Exchange Commission	<i>Publications Unit</i> 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 <i>SEC Public Reference Room</i> (202) 942-8078	<i>Information Line</i> (202) 942-8090 (ext. 3) (202) 942-8092 (tty)	www.sec.gov	<i>Information Line</i> (202) 942-8090 (202) 942-8092 (tty)

[The next page is 8071.]

AAM Section 8015

Compilation and Review Alert—2002/03

NOTICE TO READERS

The *Compilation and Review Alert—2002/03* is intended to provide CPAs with an update on recent practice issues and professional standards that affect compilation and review engagements. The document has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA.

How This Alert Will Help You

.01 The *Compilation and Review Alert—2002/03* is a nonauthoritative practice aid designed to help you as you plan and perform your 2002 and 2003 compilation and review engagements. The Alert clarifies certain existing Statements on Standards for Accounting and Review Services (SSARS), suggests ways of implementing those standards in special circumstances, points out pitfalls that frequently occur in compilation and review engagements, and addresses emerging practice issues.

.02 The knowledge the Alert delivers can assist you in achieving a more robust understanding of the business and economic environment in which your clients operate. Also, this Alert delivers information about emerging practice issues, such as controllership services and information about responsibilities for fraud and internal control, in addition to valuable current accounting, auditing, and regulatory developments.

Help Desk—Use this Alert in conjunction with the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

The U.S. Business Environment

.03 As of the third quarter of 2002, anxious economists are downgrading their forecasts, and some crucial sectors of the economy are pushing the likelihood of a rebound into next year because of the abrupt slowdown in the economic recovery.

.04 For now, the overall economy is expanding, but sluggishly. Jobs are growing, but barely. And with a depressed stock market and reactions to and further fears of terrorist strikes weighing on the national psyche, there is none of the exuberance that marked the recovery in the late 1990s.

.05 Analysts argue over whether the summer slump was just a pause in the rebound—perhaps as companies obsess about making sure their financial reports are accurate—or something more ominous. Even optimists say the once-slim chances of a double-dip recession, meaning a recession followed by a short period of growth, only to be followed by another recession, are now up to 20 percent or more.

.06 The economy appears to be in a struggle between declining business confidence and strong consumer spending. Eventually, consumer demand should overcome business wariness unless cautious businesses cut so many jobs that consumers finally give up. The same dynamic was at work during the fall of 2001. After September 11, the business sector froze, but the consumer sector did not, and eventually consumer demand jump-started the economy.

Effect of the Sarbanes-Oxley Act of 2002 on Compilation and Review Engagements

.07 The corporate-governance and accounting-oversight bill signed into law by President Bush in late July 2002 will have major consequences for executives, accountants, shareholders, and regulators. The new law creates the Public Company Accounting Oversight Board (PCAOB) to oversee the audit of public companies that are subject to the securities laws of the Securities and Exchange Commission (SEC), beefs up penalties for corporate wrongdoers, forces faster and more extensive financial disclosure, and creates avenues of recourse for aggrieved shareholders.

.08 Most of the provisions of the Sarbanes-Oxley Act apply directly to publicly held companies and their auditors. Since compilation and review engagements can only be performed on the financial statements of nonpublic entities, the act, generally, will not directly affect these engagements. However, one provision, Section 209: "Consideration by Appropriate State Regulatory Authorities," directs state regulators (such as state boards of accountancy) to make an independent determination of the proper standards applicable to small- and mid-sized nonregistered accounting firms. In light of this provision, you may want to stay abreast of further developments related to this Act. You can find a summary of the Sarbanes-Oxley Act of 2002 at www.aicpa.org/info/sarbanes_oxley_summary.htm.

Current SSARS Developments

New SSARS Interpretation on Controllorship and Other Management Services

.09 Many CPAs in public practice perform services for clients that are equivalent to some services ordinarily performed by management. These services may entail making management decisions for a client and could include actions such as the following:

- Hiring and terminating employees
- Authorizing purchases or expenditures
- Disbursing funds
- Making investment decisions
- Having custody of assets
- Making credit decisions
- Signing contracts
- Serving as an officer of the entity

Performance of these services, typically called *controllorship services*, by a CPA for a client has fueled a debate. If a CPA performs such services, should he or she comply with SSARS No. 1, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100), when submitting financial statements in connection with these services? On one hand, it can be argued that the CPA is, in substance, part of management and, therefore, should not perform a compilation on the financial statements that he or she prepares. (CPAs in industry are not required to comply with SSARS No. 1.) On the other hand, it can be argued that the CPA is in public practice and should, therefore, perform a compilation.

New Interpretation

.10 In April 2002, the Accounting and Review Services Committee (ARSC) issued an interpretation to help clarify issues involved in the debate described in the preceding paragraph. Interpretation No. 21 of

SSARS No. 1, "Applicability of SSARS No. 1 When Performing Controllorship or Other Management Services" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.80–.84), states that, if you are in the practice of public accounting as defined by the AICPA's Code of Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 92.25), and are not a stockholder, partner, director, officer, or employee of the entity, you are required to follow the performance and communication requirements of SSARS No. 1, including following any requirement to disclose a lack of independence.

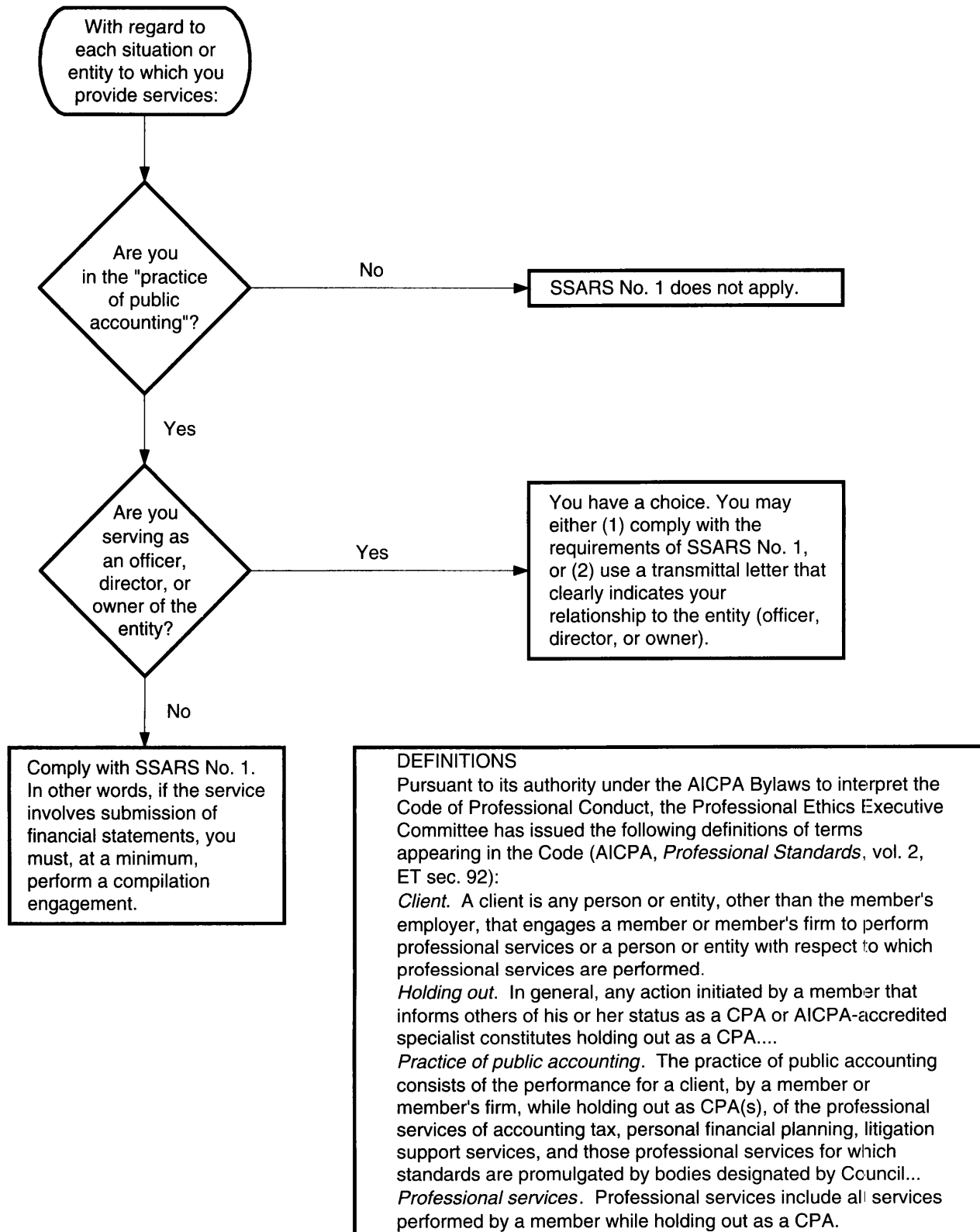
.11 If you are in the practice of public accounting and are also a stockholder, partner, director, officer, or employee of the entity, you may either (1) comply with the requirements of SSARS No. 1 or (2) communicate, preferably in writing, your relationship to the entity (for example, stockholder, partner, director, officer, or employee). The following is an example of the type of communication that you may use:

The accompanying balance sheet of Company X as of December 31, 20XX, and the related statements of income and cash flows for the year then ended have been prepared by [*Name of accountant*], CPA. I (We) have prepared such financial statements in my (our) capacity [*Describe capacity, for example, as a director*] of Company X.

.12 If you are not in the practice of public accounting, the issuance of a report under SSARS would be inappropriate; however, you can use the communication just presented above.

.13 The decision tree in Exhibit 1, "Interpretation No. 21 of SSARS No. 1, 'Applicability of SSARS No. 1 When Performing Controllorship or Other Management Services,'" may help you understand the application of this new interpretation.

Exhibit 1—Interpretation No. 21 of SSARS No. 1, "Applicability of SSARS No. 1 When Performing Controllorship or Other Management Services"



Management-Use-Only Financial Statements in Controllarship Engagements

.14 If you are in the practice of public accounting, submitting management-use-only financial statements may be a useful option to consider for your controllarship engagements. The requirements for a management-use-only compilation include the option of preparing a written engagement letter and following the compilation performance standards for any financial statements that you submit while performing these controllarship services. (See the next section of this Alert for related information.) Keep in mind, however, that the financial statements would be restricted to management's use only and would not be available to third parties. In addition, because of the nature of the services performed, you would need to add an item to the engagement letter noting your lack of independence.

SSARS No. 8 and the "Management-Use-Only" Compilation

.15 In 2000 ARSC completed work on SSARS No. 8, *Amendment to Statement on Standards for Accounting and Review Services No. 1, Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100.01–.23), the first major revision to SSARS in over 20 years.

.16 SSARS No. 8 makes fundamental changes to the way in which accountants view the compilation engagement. Rather than simply trying to exempt certain financial statement engagements, ARSC rewrote SSARS No. 1, which resulted in SSARS No. 8, a standard that retains the best of what SSARS No. 1 has always offered. In fact, the standard does not change professional standards for review engagements; nor does it change the performance standards for compilation engagements. Rather, SSARS No. 8 adds new options to make SSARS No. 1 more flexible.

Review of Significant Changes: Submission of Financial Statements and an Added Communications Options

.17 As you may know, these two things have changed as a result of SSARS No. 8:

- The definition of *submission of financial statements* (which "triggers" the application of SSARS No. 1)
- The addition of communication options in certain circumstances

.18 *Submission of financial statements* is now defined in AR sec. 100.04 as "presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software." This substantial change from the previous definition that referred to "generating financial statements or modifying client-prepared financial statements" is important to understand.

.19 Note that the following two actions on the part of the practitioner are necessary in order to *submit* financial statements:

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

.20 Absent either of these actions, the financial statements have not been submitted, and SSARS No. 1 is not applicable. Let's look more closely at what these terms imply.

.21 SSARS No. 1 does not define the term *prepared*. Rather, you must use your professional judgment to determine whether you are going to prepare a financial statement. In making this judgment, you should consider the difference between bookkeeping services (for example, making adjustments, corrections, and accruals) and the preparation of financial statements. There is no definitive line that, when crossed, would indicate that you are submitting financial statements. Therefore, you should establish a firm policy to evaluate how certain accounting services are classified within your firm.

.22 The term *presenting* is also not defined in SSARS No. 1. Again, you will have to use your professional judgment to determine whether you are going to present financial statements to a client. Obviously, physically presenting printed financial statements would meet the definition used here. Other situations, however, warrant careful consideration.

.23 The second change involves communications options. The compilation report has long been the vehicle by which you communicate, among other things, your degree of responsibility for the financial statements to the financial statement user. However, for engagements in which the financial statements are *not expected to be used by third parties*, you can now compile the financial statements and choose between the communications options of (1) the standard compilation report or (2) an engagement letter.

.24 There are other important requirements that you need to understand in order to compile management-use-only financial statements. Before offering this service to your clients, make sure you completely understand the issues related to this type of engagement, such as third parties and required legends on the financial statements, among others.

.25 The changes were effective for financial statements submitted after December 31, 2000

Help Desk—The AICPA published a Practice Aid to assist practitioners in implementing changes related to SSARS into their practice. You can obtain the AICPA Practice Aid, *Understanding and Implementing SSARS No. 8* (product no. 006612kk) by calling the AICPA Order Department at (888) 777-7077.

New SSARS Exposure Draft: Omnibus—2002

.26 Periodically, ARSC issues an omnibus statement if the significance of the issues and cost/benefit considerations does not, in and of itself, warrant the issuance of separate standards. The proposed omnibus statement includes proposed revisions to existing SSARS that have been accumulated over a period of time and addresses the following issues:

- The auditing literature allows an accountant who may be associated with the financial statements of a public company, but has not audited or reviewed such statements, to state that he or she has not audited the unaudited information and includes example report wording. This guidance is also appropriate for compilation and review engagements; however, SSARSs currently do not include example wording. This amendment will revise SSARS No. 1 (AR sec. 100.03) to include wording that may be appropriate in the circumstances.
- The accounting literature does not require the statement of retained earnings to be presented as a financial statement. Accounting Principles Board (APB) Opinion No. 12, *Omnibus Opinion—1967*, requires the disclosure of a change in capital. The disclosure can be accomplished by the preparation of a separate statement in the notes to the financial statements or as a presentation as part of another basic statement. In addition, the example reports in SSARS currently do not refer to the statement of comprehensive income. This amendment will include two footnotes to SSARS No. 1 (AR sec. 100.14 and .36), stating (1) the statement of retained earnings is not a required statement and, if not presented as a separate statement, reference in the compilation and review report is not needed, and (2) if the statement of comprehensive income is presented, reference should be made in the appropriate paragraphs of the report.
- SSARS currently do not specifically require a signature of the accounting firm or the accountant on a review or compilation report. This proposed amendment will revise SSARS No. 1 (AR sec. 100.11 and .33) to require a signature (which may be manual, electronic, stamped, or typed).
- The current guidance found in SSARS No. 1 (AR sec. 100.29) requires the accountant to obtain a representation letter from management. The guidance is not specific about the content of the letter,

the dating of the letter, and current management's responsibility regarding previous years. This amendment will require specific representations for the accountant to receive from management when performing a review engagement and will provide guidance on the dating of the letter and guidance regarding obtaining representations from current management when they were not present during all periods covered by the accountant's report.

- SSARS No. 1 (AR sec. 100.44) includes guidance on reporting on supplementary information. Currently, the guidance is unclear with respect to separate reporting on supplementary information in a compilation engagement. This proposed amendment would explicitly allow for a separate report on supplementary information in a compilation engagement, consistent with guidance on supplementary information in a review report.
- SSARS currently do not refer to the Statements on Quality Control Standards (SQCS) and how those standards interact with SSARS. The proposed amendment will clarify the idea that, although an effective quality control system is conducive to compliance with SSARS, deficiencies in or noncompliance with a firm's quality control system do not, in and of themselves, indicate that an engagement was not performed in accordance with the applicable professional standards. This amendment would be included as the last section of SSARS No. 1.
- SSARS No. 4, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*, vol. 2, AR sec. 400), provides guidance on communications between accountants if the successor accountant decides to communicate with the predecessor regarding the acceptance of an engagement. Among other things, this amendment defines predecessor and successor accountants, provides guidance regarding the acceptance of an engagement, suggests inquiries that the successor accountant may decide to direct toward the predecessor accountant, and includes an example of a successor accountant acknowledgment letter, which the predecessor may want to use in connection with granting access to the working papers.

Current Practice Issues

Bookkeeping Services Versus Compilation of Financial Statements

.27 SSARS No. 1 is applicable whenever you submit unaudited financial statements of a nonpublic entity to your client or third parties. SSARS No. 8 modified the definition of *submission*. Submission of financial statements is now defined as follows (AR sec. 100.04):

Presenting to a client or third parties financial statements that the accountant has prepared either manually or through the use of computer software.

[See the "SSARS No. 8 and the 'Management-Use-Only' Compilation" section earlier in this Alert for a more detailed discussion of this definition.]

.28 If the client does not need audited or reviewed financial statements, you can choose from these three types of engagements:

- A "traditional" compilation (required if third parties will use the financial statements)
- A "management-use-only" compilation (available if third parties will not use the financial statements)
- Bookkeeping services (available if the procedures do not include the submission of financial statements)

.29 You should consider making the decision about the best type of engagement for your client early in the engagement planning process and base the decision on a combination of factors, including (1) the needs of the client and other users, (2) your knowledge of the client, and (3) the nature of the procedures you will perform.

.30 If your client does not need compiled financial statements you may, instead, choose to perform only bookkeeping services. Other than the broad general ethical guidance available in the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 201), there are no authoritative standards for bookkeeping services. Thus, it is wise to at least establish a written understanding with the client concerning bookkeeping services. This understanding should include:

- A description of the nature and limitations of the services
- A statement that the engagement cannot be relied upon to detect errors, fraud, or illegal acts

.31 Although not an authoritative requirement, a written engagement letter for a bookkeeping services engagement could be important because there are no specific standards to follow for these types of engagements. (Appendix A, "Bookkeeping Services—Illustrative Engagement Letter," includes an example.) Other professional engagements, such as audits, reviews, and compilations, include the added benefit of authoritative standards that define the engagement objectives, limitations, communications, and so on.

Documentation Requirements for SSARS Engagements

Compilation Engagement Documentation

.32 SSARS No. 1 does not require any specific documentation in a compilation engagement. However, SSARS No. 1, as amended by SSARS No. 8, does require documentation of the understanding with the client in the form of a written engagement letter for a management-use-only compilation (if a compilation report is not to be issued). Although not required (except for the engagement letter as just indicated), including the types of documentation noted below may be helpful from a risk management and quality control perspective:

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, procedural checklists, and disclosure checklists

Review Engagement Documentation

.33 SSARS No. 1 states that, in a review engagement, the accountant should have documentation to describe the following (AR sec. 100.29 and .32):

1. Matters covered in your inquiry and analytical procedures
2. Unusual matters (incorrect, incomplete, or unsatisfactory information) that you considered and how those matters were resolved
3. Management representation letter (SSARS No. 1 requires that the client provide you with a representation letter in a review engagement.)

.34 Accountants typically include the following additional items in their review engagement documentation:

1. Engagement letter
2. A working trial balance
3. If required by firm policy, review work program, procedural checklists, and disclosure checklists

Responsibility for Fraud

.35 You are not required to document your assessment of fraud or gain an understanding of internal control in a compilation or review engagement. Further, you are not required to plan or perform a compilation or review engagement to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Nor are you required to gain an understanding of the client's internal control when conducting a compilation or review engagement. This does not, however, relieve you of responsibility if incorrect, incomplete, or otherwise unsatisfactory information comes to your attention during the engagement.

.36 SSARS No. 1 (AR sec. 100.09) requires you to obtain additional or revised information if you become aware, while conducting a compilation engagement, that information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory. If the client refuses to provide additional or revised information, you should withdraw from the engagement.

.37 In a review engagement, if you become aware that information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory, you should perform the additional procedures you deem necessary to achieve limited assurance that there are no material modifications that should be made to the financial statements for them to be in conformity with generally accepted accounting principles (GAAP).

.38 Although management is responsible for the prevention and detection of fraud and the maintenance of internal control, many small business clients do not understand management's responsibility. These clients may have unrealistic expectations and may assume that you are providing a higher level of assurance than you were engaged to do, including detecting fraud and internal control weaknesses. We present here some ways for you to clarify for your client each party's responsibility.

.39 Paragraph 5 of SSARS No. 1 (AR sec. 100.05) states:

The accountant should establish an understanding with the entity, preferably in writing, regarding the services to be performed . . . the understanding should include a description of the nature and limitations of the services to be performed and a description of the report, if a report is to be issued. The understanding should also provide (a) that the engagement cannot be relied upon to disclose errors, fraud, or illegal acts and (b) that the accountant will inform the appropriate level of management of any material errors that come to his or her attention and fraud or illegal acts that come to his or her attention, unless they are clearly inconsequential.

.40 A written engagement letter, though not required in a compilation or review engagement (except in the case of a management-use-only compilation), may be helpful in clarifying and documenting your understanding with the client about your responsibility regarding fraud and internal control weaknesses. The language suggested for use in the review engagement letter is illustrated in Appendix E of SSARS No. 1 (AR sec. 100.57) as follows:

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 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.

.41 Similarly, the language illustrated in Appendix C and D of SSARS No. 1 (AR sec. 100.55 and 100.56) for an engagement letter for a compilation engagement is as follows:

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 clearly inconsequential.

.42 Language can also be added to a compilation engagement letter to indicate that a compilation does not require you to obtain an understanding of the entity's internal control or identify internal control weaknesses.

.43 In addition to providing a clearly expressed engagement letter, a second way to minimize misunderstandings is to make clear to your client his or her responsibility to prevent and detect fraud. An effective way to do this is to educate your client as to the importance of internal control in the prevention of fraud. You are then in a position to work with the client in a separate consulting engagement to improve the client's internal control. This exercise results in several benefits for both you and the client. One benefit is the client's increased awareness of the importance of internal control in the prevention and detection of fraud. In addition, this exercise clarifies management's responsibility to prevent and detect fraud, thereby reducing your legal risk. Finally, in the process of offering this type of consulting services to the client, you have the opportunity to gain knowledge of the client's business, thereby becoming more valuable to the client.

Political Campaign Reporting

.44 Candidates running for elected office generally are required by state or federal law to file a report with the applicable state or federal regulatory agency indicating amounts and sources of contributions received and the amounts and purposes of expenditures made during a specified period. Many campaign reports include, in addition to several other preprinted forms, a form requiring the following information:

- Subtotals of each type of receipt and a total of all receipts
- Subtotals of each type of disbursement and a total of all disbursements
- A financial summary beginning with funds on hand at the beginning of the period, adding total receipts for the period, subtracting total disbursements for the period, and ending with total funds on hand at the end of the period

.45 Paragraph 4 of SSARS No. 1 (AR sec. 100.04) defines a *financial statement* as:

A presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with generally accepted accounting principles (GAAP) or a comprehensive basis of accounting other than GAAP.

.46 Further, paragraph 2 of SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AR sec. 300.02) defines a *prescribed form* as follows:

Any standard preprinted form designed or adopted by the body to which it is to be submitted, for example, forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities. A form designed or adopted by entity whose financial statements are to be compiled is not considered to be a prescribed form.

.47 Based on these two definitions, the financial presentation described above is a prescribed-form financial statement that must be compiled in accordance with SSARS No. 3 (AR sec. 300).¹ However, if you

¹ The requirements of SSARS No. 1 are applicable when the unaudited financial statements of a nonpublic entity are included in a prescribed form. SSARS No. 3 amended SSARS No. 1 to provide for an alternative form of standard compilation report.

are serving as treasurer for the candidate or campaign committee, you have the option of communicating, preferably in writing, your relationship to the candidate or campaign, instead of issuing a SSARS No. 3 report. (See the previous section of this Alert entitled “New SSARS Interpretation on Controllorship and Other Management Services.”) The following is an example of the type of communication that you may use:

The accompanying (identification of financial statements, including period covered and name of entity) included in the accompanying prescribed form have been prepared by [Name of accountant], CPA. I have prepared such financial statements in my capacity as Treasurer of (identify candidate or campaign).

.48 Also, keep in mind that Ethics Ruling No. 82, “Campaign Treasurer” of Rule 101, *Independence*, of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 191.164–.165), addresses independence considerations for campaign treasurers. The Ruling states that if a member serves as the campaign treasurer of a mayoral candidate, independence would not be considered to be impaired with respect to the political party or municipality. However, if *any* partner or professional employee of the firm served as campaign treasurer, independence would be considered to be impaired with respect to the campaign organization.

Quality Control Standards

.49 Statements on Quality Control Standards are a framework for quality control in a CPA firm that apply to both compilation and review engagements and to many areas beyond these two types of engagements.

.50 The standards established by SQCS apply to a firm’s accounting and auditing practice, which SQCS No. 2, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice* (AICPA, *Professional Standards*, vol. 2, QC sec. 20), defines as follows:

Accounting and auditing practice refers to 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 Rules 201 or 202 of the AICPA Code of Professional Conduct.

.51 Although SSARS No. 1 currently does not refer to the SQCS, ARSC is amending SSARS No. 1 to refer to the SQCS and explain how those standards interact with SSARS. (See the previous section of this Alert entitled “New SSARS Exposure Draft: Omnibus—2002.”) The proposed amendment will clarify that, although an effective quality control system is conducive to compliance with SSARS, deficiencies in or noncompliance with a firm’s quality control system do not in and of themselves indicate that an engagement was not performed in accordance with the applicable professional standards.

Tailoring the Representation Letter

.52 SSARS No. 1 requires that, in a review engagement, you obtain a representation letter from members of management whom you believe are responsible for and knowledgeable about the matters covered in the representation letter. A management representation letter is not required in a compilation engagement. (However, the AICPA’s *Personal Financial Statements* Guide recommends that practitioners obtain a representation letter in all personal financial statement engagements, even in a compilation.)

.53 Normally, the chief executive officer and chief financial officer would sign the management representation letter. Appendix F of SSARS No. 1 (AR sec. 100.58) provides an illustrative management representation letter for a review engagement.

.54 You should tailor the management representation letter to the client based on your knowledge of the client’s business and the industry in which it operates. You may add additional representations to the letter,

especially if the client operates in a specialized industry (e.g., construction contractors, homeowners associations, or not-for-profit organizations.). These additional representations may be found in various AICPA Industry Audit and Accounting Guides that you can obtain by calling the AICPA Order Department at (888) 777-7077.

.55 ARSC has issued an omnibus exposure draft that will, among other things, require specific representations from management and provide guidance on both dating the representation letter and obtaining representations from current management if they were not present during all periods covered by the review report. (See the previous section of this Alert, "New SSARS Exposure Draft: Omnibus—2002.") Some of the following issues, although they are only recommended at this time, may become requirements if the omnibus statement is adopted.

.56 Obtain written representations from management for all financial statements and periods covered by your report. For example, if comparative financial statements are reported on, the representations obtained at the completion of the most recent review should address all periods being reported. The specific written representations obtained will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. In connection with a review of financial statements presented in accordance with GAAP, specific representations should relate to the following matters:

- a. Management's acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with GAAP
- b. Management's belief that the financial statements are fairly presented in conformity with GAAP
- c. Management's full and truthful response to all inquiries
- d. Completeness of information
- e. Information concerning subsequent events

.57 The written representations should be addressed to the accountant. Because you are concerned with events occurring through the date of the 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 your report. The letter should be signed by those members of management who you believe are responsible for and knowledgeable, directly or through others in the organization, about the matters covered in the representation letter. Normally, the chief executive officer and chief financial officer or others with equivalent positions in the entity should sign the representation letter. If current management was not present during all periods covered by your report, you should nevertheless obtain written representations from current management on all such periods.

.58 Paragraph 48 of SSARS No. 1 (AR sec. 100.48) states that if, in an audit or review engagement, a client does not provide you with a signed representation letter, you are precluded from issuing a review report on the financial statements and would ordinarily be precluded from issuing a compilation report on the financial statements. Thus, you would not be able to step down to a compilation engagement.

Current Accounting and Reporting Issues

Accounting for Goodwill

.59 In June 2001, the FASB issued Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets*, which supersedes APB Opinion No. 17, *Intangible Assets*, and drastically changes the accounting for goodwill. FASB Statement No. 142 changes the

unit of account for goodwill and takes a very different approach to how to account for goodwill and other intangible assets subsequent to their initial recognition. Because goodwill and some intangible assets will no longer be amortized, the reported amounts of goodwill and intangible assets will not decrease at the same time and in the same manner as under previous standards. Specifically, FASB Statement No. 142 changes the subsequent accounting for goodwill and other intangible assets in the following respects:

- FASB Statement No. 142 adopts a more aggregate view of goodwill and bases the accounting for goodwill on the units of the combined entity into which an acquired entity is integrated. Those units are referred to as reporting units.
- APB Opinion No. 17 presumed that goodwill and all other intangible assets were wasting assets (that is, finite lived). FASB Statement No. 142 does not presume that those assets are wasting assets. Instead, goodwill and other intangible assets that have indefinite useful lives will not be amortized but, rather, will be tested at least annually for impairment.
- FASB Statement No. 142 provides specific guidance for testing goodwill for impairment. The annual test for goodwill impairment uses a two-step process that begins with an estimation of the fair value of a reporting unit. However, if certain criteria are met, the requirement to test goodwill for impairment annually can be satisfied without a remeasurement of the fair value of the reporting unit.

.60 The provisions of FASB Statement No. 142 are required to be applied, starting with fiscal years beginning after December 15, 2001. This Statement is required to be applied to all goodwill and other intangible assets recognized in the financial statements at that date. Goodwill and intangible assets acquired after June 30, 2001, are subject immediately to the nonamortization provisions of FASB Statement No. 142.

.61 Many accountants have voiced concern that the cost of complying with FASB Statement No. 142 may exceed the benefits for many small businesses which need compiled or reviewed financial statements. FASB Statement No. 142 requires that companies test goodwill for impairment at least annually. This impairment test involves estimating the fair value of all assets and liabilities and comparing the resulting net assets to the fair value of the reporting unit (or entity). This estimation and comparison procedure can be costly in terms of time and personpower.

.62 If your client chooses not to implement FASB Statement No. 142, you should modify your compilation or review report to disclose the GAAP departure. You also should disclose the dollar effects of the departure in the report if the client has determined them or if they are known as a result of your procedures. SSARS No. 1 (AR sec. 100.42) provides guidance when any amounts are believed so material that a GAAP exception is not enough. However, you are not required to determine the effects of the departure if the client has not determined and provided them. In those cases, include in the report a statement that the effects of the departure have not been determined. The following reports illustrate how you might communicate this departure.

Compilation Report With a GAAP Departure

.63

We have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, 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 described in the following paragraph.

Generally accepted accounting principles require that goodwill be tested for impairment and not be amortized. Management has informed me (us) that the Company has not tested goodwill for impairment and is continuing to amortize goodwill. The effects of this departure from generally accepted accounting principles have not been determined.

Review Report With a GAAP Departure

.64

I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, 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.

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 our review, with the exception of the matter described in the following paragraph, I (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 goodwill be tested for impairment and not be amortized. Management has informed me (us) that the Company has not tested goodwill for impairment and is continuing to amortize goodwill. The effects of this departure from generally accepted accounting principles have not been determined.

Statement of Retained Earnings

.65 Some practitioners question whether a statement of retained earnings is required in a financial statement presentation. This confusion arises, partly, because all of the example reports in SSARS No. 1 refer to a statement of retained earnings.

.66 The accounting literature does not require the statement of retained earnings to be presented as a financial statement. However, APB Opinion No. 12, *Omnibus Opinion—1967*, does require disclosure of a change in capital. This disclosure can be made in a separate financial statement, in the notes to the financial statements, or as part of another basic statement (such as the income statement or balance sheet).

.67 SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), contains the requirements for a presentation of financial statements prepared on a comprehensive basis of accounting other than GAAP. We refer to this basis of presentation as an other comprehensive basis of accounting (OCBOA). Generally, two financial statements—one that presents the financial position of the entity and one that presents the results of operations of the entity—will constitute a complete presentation. However, financial statements prepared using an OCBOA, such as cash basis or tax basis, should include disclosures similar to those included in GAAP presentations. Therefore, disclosure of a change in capital, as required by APB Opinion No. 12, would be appropriate for cash- or tax-basis financial statements.

.68 In general, you have three options for presenting information about retained earnings or changes in capital:

- Present a separate statement of retained earnings.
- Include a disclosure of the change in capital (retained earnings) in the notes to the financial statements.
- Present the change in capital (retained earnings) on the face of the income statement or in the equity section of the balance sheet.

Reporting When Supplementary Information Is Included

.69 Two common questions arise when supplementary information is included with the basic financial statements:

1. What is considered supplementary information, and where do I place it in the presentation?
2. Do I have to modify the standard compilation or review report if supplementary information is included?

What Is Supplementary Information?

.70 The term *supplementary information* is not defined in SSARS. SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), defines this type of information as:

- Additional details of items in or related to the basic financial statements, unless the information has been identified as being part of the basic financial statements
- Consolidating information
- Historical summaries of items extracted from basic financial statements, including graphs prepared on a computer
- Statistical data
- Other material, some of which may be from sources outside the accounting system or outside the entity

Presentation of Supplementary Information

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

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

.72 Normally, supplementary information is separated from the basic financial statements. Most practitioners present supplementary information on separate pages after the basic financial statements (and footnotes, if included). It is also a good idea to separate the supplementary information from the basic financial statements by including a title page marked "Supplementary Information." If you present a separate report on the supplementary information, it should follow the title page.

.73 SSARS No. 1 requires that you indicate the degree of responsibility, if any, you are taking with respect to the supplementary information that accompanies the basic financial statements.

.74 If the basic financial statements are compiled, then the compilation report should be modified, as follows:

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

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

.75 If the basic financial statements are compiled for management's use only, then the engagement letter should include the following language:

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

.76 If the basic financial statements are reviewed, the degree of responsibility you are taking is indicated either in your review report on the basic financial statements or in a separate report on the other data. Specifically, the explanation should state that the review was made primarily for the purpose of expressing limited assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with GAAP, and, according to SSARS No. 1 (AR sec. 100.44) either:

- The other data accompanying the financial statements are presented only for supplementary analysis purposes and have been subjected to the inquiry and analytical procedures applied in the review of the financial statements, and you did not become aware of any material modifications that should be made to such data (in other words you are stating that you also *reviewed* the supplementary information), or
- The other data accompanying the financial statements are presented only for supplementary analysis purposes and have not been subjected to the inquiry and analytical procedures applied in the review of the financial statements, but were compiled from information that is the representation of management, without audit or review, and you do not express an opinion or any other form of assurance on such data (in other words, you are stating that you reviewed the financial statements but only *compiled* the supplementary information).

.77 In any case, the important thing to remember is to clearly indicate the degree of responsibility you are taking for any information accompanying the basic financial statements.

.78 The ARSC has issued an exposure draft that will allow for a separate report on supplementary information. SSARS No. 1 currently implies that the reference to the supplementary information should be made only in the compilation report on the financial statements. (See the previous section of this Alert, "New SSARS Exposure Draft: Omnibus—2002.")

Financial Statements Submitted in Litigation Support Services

.79 Accountants who provide litigation support services may be asked to prepare financial presentations for their client's submission to the court. Ordinarily, the submission of such financial statements would require that you at least compile the financial statements in accordance with SSARS No. 1. However, Interpretation No. 20 of SSARS No. 1, "Applicability of Statements on Standards for Accounting and Review Services to Litigation Services" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.76-.79), exempts such financial statements from the applicability of SSARS if the following apply:

1. The statements are submitted in conjunction with litigation services that involve pending or potential formal legal or regulatory proceedings before a trier of fact.
2. The services are in connection with the resolution of a dispute between two or more parties.
3. One of the following criteria must be met:
 - a. The service consists of being an expert witness.
 - b. The service consists of being a trier of fact or acting on behalf of one.
 - c. The accountant's work under the rules of the proceedings is subject to detailed analysis and challenge by each party to the dispute.
 - d. The accountant is engaged by an attorney to do work that will be protected by the attorney's work product privilege and such work is not intended to be used for other purposes.

.80 In legal proceedings, other parties are provided with access to the financial statements submitted to the court and also have the opportunity to analyze and challenge the financial statements. This would meet the criteria in item 3c above, and because the first two requirements (items 1 and 2, above) are also met, would exempt the financial statements from the applicability of SSARS No. 1.

.81 It should be noted that SSARS No. 1 would be applicable to financial statements submitted in connection with litigation services if, under the rules of the proceedings (1) the parties did not have the opportunity to analyze and challenge the accountant's work or (2) if the accountant was specifically engaged to compile and report on the financial statements.

.82 The AICPA Litigation and Dispute Resolution Subcommittee has issued an exposure draft Statement on Responsibilities (SOR) for Litigation Services No. 1. The exposure draft sets forth the responsibilities of a litigation service practitioner in a litigation service consulting engagement. The SOR analyzes the scope of litigation services, provides a comparative analysis of standards and responsibilities, and describes the scope of standards and responsibilities for the litigation service practitioner.

.83 The SOR is based upon an Interpretation of the Statement on Standards for Consulting Services and incorporates special reports that have previously been issued by the AICPA (*Application of AICPA Professional Standards in the Performance of Litigation Services, Consulting Services Special Report 93-1*) as well as elements of other special reports that have been issued by the AICPA.

Compiling or Reviewing Under a Different Basis of Accounting

.84 A client may engage you to compile GAAP financial statements in one year (for example, 2002) because such statements are needed to obtain bank financing, and in the following year (2003) when the client is no longer applying for credit, engage you to compile comparative tax-basis financial statements for the current and prior years (2002 and 2003). If such an engagement is performed, two financial statements with different bases of accounting will have been issued for the same period (2002).

.85 Although SSARS does not address this question, nothing in SSARS precludes you from performing such an engagement. Relevant guidance in this area may be gleaned from SAS No. 62, *Special Reports*, which

provides guidance on reporting on financial statements prepared in conformity with an OCBOA other than GAAP, as noted previously in this Alert. Footnote 35 of SAS No. 62 primarily addresses situations in which GAAP financial statements have been issued in previous years and the entity changes the basis of accounting used in the current year. Footnote 35 indicates that, in such situations, the auditor is not required to add an explanatory paragraph to the report describing the change. However, the auditor may add an explanatory paragraph to the report to highlight (1) a difference in the basis of presentation used from that in prior years or (2) that another report has been issued on the entity's financial statements prepared in conformity with another basis of accounting. Drawing a parallel from the guidance in the audit literature, it would appear that you need not modify your compilation report in this situation; however, if you wish to, you may add a paragraph to the report indicating that another report has been issued on the entity's financial statements prepared in conformity with another basis of accounting.

.86 If two sets of financial statements with different bases of accounting have been issued for the same period, it is particularly important that readers be aware of the basis of accounting used in each set of financial statements. Ordinarily, the basis of accounting is disclosed in the notes to the financial statements. However, in financial statements that omit substantially all disclosures required by GAAP or OCBOA, the basis of accounting may not be disclosed in the financial statements. Interpretation No. 12 of SSARS No. 1, "Reporting on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.41–45), ensure that the basis of accounting is disclosed to financial statement users by requiring that it be disclosed in the compilation report if it is not disclosed in the financial statements.

Pro Forma Information

.87 A client who is considering entering into an important transaction, such as acquiring another entity, may ask you to compile pro forma financial information related to that transaction. The objective of pro forma financial information is to present historical financial information as if a proposed or consummated transaction had occurred at the date of the historical financial information. The pro forma financial information may consist of financial statements or selected elements of a financial statement. Pro forma financial information is prepared by making pro forma adjustments to historical financial information. The adjustments are based on management's assumptions and should reflect all of the significant effects that would be directly attributable to the proposed transaction or event. For example, in 2002, Company A may be considering acquiring Company B and would like to determine what the December 31, 2001, financial statements would have looked like had that acquisition occurred during 2001. The client, with your assistance, would prepare pro forma financial statements that reflect all of the significant factors that would have affected the historical financial statements. These factors might include items such as increased labor costs if the acquisition involves the use of employees covered by a collective bargaining agreement, or the tax effects of operating in a new locality. In other situations, such as the following, pro forma financial information may be useful to show the effects of transactions:

- The disposition of a significant portion of a business, such as the sale of a division
- A change in the form of a business organization, such as the incorporation of a sole proprietorship
- The sale of securities and the application of the proceeds, such as the issuance of debt or equity securities and the use of the proceeds to purchase additional manufacturing equipment

.88 Chapter 4, "Reporting on an Entity's Internal Control Over Financial Reporting," of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 401), establishes standards for examining or reviewing pro forma financial information. However, that standard does not apply to the compilation of pro forma financial information. In Technical Practice Aid (TPA) No. 9, "Compilation of Pro Forma Information" (AICPA, *Technical Practice Aids*, vol. 1, sec. 9160.09), an inquiry is made as to whether an accountant may compile pro forma financial information if the related historical financial statements have been compiled. The TPA states that

an accountant may compile pro forma financial information because AT sec. 401 does not prohibit such a service. Although there is no authoritative guidance for compiling such information, you should consider the importance of the following:

- Obtaining a general understanding of the underlying transaction or event that created the need for the pro forma financial information
- Considering whether management's assumptions underlying the pro forma adjustments are disclosed in the notes to the pro forma financial information and whether the pro forma adjustments appear to be consistent with each other and with the data used to develop them

.89 If the historical financial statements have been compiled, the pro forma financial information may be presented as supplementary information accompanying the historical financial statements, and you may report on the pro forma financial information in accordance with the guidance on supplementary information presented in paragraph 44 of SSARS No. 1 (AR sec. 100.44). (Also, see the discussion in the previous section of this Alert, "Reporting When Supplementary Information Is Included.")

Split-Level Reporting

.90 Split-level reporting involves providing different levels of assurance on a single set of financial statements for the same year. For example, this type of reporting would include auditing the balance sheet and reviewing the income statement.

.91 Neither the SSARS nor the SAS address whether you can audit a balance sheet and review an income statement for the same set of financial statements. Many practitioners believe that an engagement involving an audit of one statement and a review of another statement should be avoided.

.92 Consider the case of a first-year audit in which you have not observed the beginning inventory. You sometimes find that you cannot express an opinion on the statements of income and cash flows in these circumstances. You may, however, be able to express an unqualified opinion on the balance sheet. In such a situation, is it permissible to audit the balance sheet and compile or review the statements of income and cash flows?

.93 If you encounter such a situation, follow the guidance in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), and indicate that you do not express an opinion on the statements of income and cash flows. Because you have applied audit procedures to the results of operations and the statement of cash flows, except for beginning inventory, best practice suggests that you should avoid engagements that combine SAS and SSARS requirements.

.94 What about an engagement involving a reviewed balance sheet and a compiled statement of income? Is this type of split approach appropriate for practitioners to consider? Again, this is not addressed in the SSARS; thus, it is not prohibited. However, most practitioners believe that it is sound practice to avoid this type of engagement. Another determining factor to consider is that, if one statement has been reviewed, the additional work necessary to review the other statement (instead of compiling the other statement) is minimal.

Reporting on Financial Statements That Omit Substantially All Disclosures

.95 Your client may request you to compile financial statements that omit substantially all disclosures. You may compile financial statements that omit substantially all disclosures, provided you disclose the omission in the compilation report and the omission is not, to your knowledge, an attempt to mislead anyone. Since the omission of disclosures is a departure from GAAP, the report must clearly indicate the departure. SSARS No. 1 (AR sec. 100.16–.18) indicates that the following should be included GAAP financial statements:

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

.96 For OCBOA financial statements, the following should be included:

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

.97 If the client wishes to include disclosures about only a few matters in the form of notes to the compiled financial statements, such disclosures should be labeled "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included." In this case, the third paragraph is still necessary in the report.

.98 Interpretation No. 1 of SSARS No. 1 (AR sec. 9100.01) indicates that the above modification for compiled financial statements is not appropriate for reviewed financial statements. Since the omission of material disclosures is a departure from GAAP, the review report should include the omitted disclosures.

.99 When the financial statements include all disclosures except one or two, the guidance above is not appropriate. Rather, the omission of a single note should be treated in a compilation or review report like any other departure from GAAP, and you should disclose the nature of the departure and its effects, if known. In addition, the paragraphs above should not be used in situations in which substantially all disclosures are included. In other words, these paragraphs are not intended to be a form of protection for forgetting to include one or more disclosures.

Current Peer Review Issues

Review of Documentation Expected in an Engagement

.100 In 1999, the AICPA Peer Review Board adopted revisions to the AICPA Standards for Performing and Reporting on Peer Reviews (Standards) and Interpretations that became effective for peer reviews commencing on or after January 1, 2001. There are now three types of peer reviews, per the AICPA Standards for Performing and Reporting on Peer Reviews:

- *System review.* This kind of review is for firms that perform engagements under the SAS, *Governmental Auditing Standards* (GAS, also referred to as the Yellow Book), and examinations of prospective financial information under the SSAE. The system review is essentially the same as the former on-site peer review with only a name change.
- *Engagement review.* This kind of review is for firms that are not required to have a system review (and who are not eligible to have a report review discussed below). The engagement review is similar to the former off-site peer review (with a separate report and letter of comments, technical review, committee acceptance, monitoring actions, and so on). In an engagement review, the two objectives are to provide the peer reviewer with a reasonable basis for expressing limited assurance of the following:
 - The financial statements or information and the related accountant's report on the accounting, review, and attestation engagements submitted for review conform in all material respects with professional standards (same as in the former off-site review).

- The reviewed firm's documentation on the engagements submitted for review conforms to the requirements of the SSARS and the SSAE, as applicable, in all material respects. In an engagement review, there is no opinion on the reviewed firm's system of quality control and, therefore, the reviewer is not opining on the firm's design of or compliance with its own quality control policies and procedures or with quality control standards.
- *Report review.* Firms that only perform compilations that omit substantially all disclosures will have a report review.

.101 Many accountants who perform only compilation and review engagements will be subject to the engagement review discussed above. In this case, you will be expected to submit selected engagements to the peer reviewer, including financial statements, reports, and documentation. However, since SSARS does not require any specific documentation in a compilation engagement, none should be expected to be submitted (see the discussion in the "Documentation Requirements in SSARS Engagements" section earlier in this Alert). The one exception, in the case of a compilation engagement, is the management-use-only compilation. In this kind of compilation, you are required to document your understanding with the client (that is, in a written engagement letter). That understanding is required to address specific items outlined in SSARS No. 1 (AR sec. 100.21).

.102 As noted in the "Review Engagement Documentation" section of this Alert, for a review engagement, SSARS No. 1 (AR sec. 100.29 and .32) states that the accountant should have documentation to describe the following:

1. The matters covered in your inquiry and analytical procedures
2. Unusual matters that you considered during the performance of the review, including their disposition
3. The management representation letter (SSARS No. 1 requires that the client provide you with a representation letter in a review engagement.)

.103 However, SSARS does not provide any specific guidance as to the form and content of the documentation to support items 1 and 2 above. Since professional standards do not provide specific guidelines as to the form and content of documentation required for review engagements, other than management representation letters, many accountants question what kind of documentation will be required from peer reviewed firms when they are subject to an engagement review.

.104 In order to clarify what constitutes appropriate documentation for a review engagement, the staff of the AICPA Peer Review Program discussed this matter with ARSC. It is ARSC's position that the form and content of documentation for a review engagement should be based upon the judgment of the accountant who performs the review engagement. Therefore, the judgment of the accountant appears to be the key factor in determining:

1. The nature and extent of inquiries to be made by the accountant when performing a review of financial statements
2. The form and content of documentation to be provided by the accountant as support for inquiries, analytical procedures, and any unusual matters considered during the performance of the review

.105 Examples of appropriate documentation for a review engagement may include one or more of the following:

- A program or checklist that covers the inquiries made by the accountant, such as those generally described in paragraph 28 of SSARS No. 1 (AR sec. 100.28) and also those more specifically described in Appendix B of SSARS No. 1 (AR sec. 100.54)

- Notations in the working papers or memos that describe the analytical procedures performed, such as comparison of financial statements with comparable prior periods, comparison of financial statements with anticipated results, ratio analysis, and also, the conclusions reached by the accountant based on the performance of those analytical procedures
- Memos in a narrative format that discuss any unusual matters the accountant considered during the review, as well as how the accountant disposed of those matters

.106 Since the form and content of documentation may vary from one engagement to another, and will be based on the judgment of the accountant who performed the review engagement, the peer reviewer will need to use reasonable judgment in determining whether the documentation appears to be appropriate.

Recurring Deficiencies Noted in Compilation and Review Engagements

.107 Of the more than 30,000 firms in the AICPA Peer Review Program, almost 18,000 perform reviews or compilations as their highest level of service. More than 40 state administering entities administer the peer review program to include 54 state CPA societies (including the District of Columbia, Guam, Puerto Rico, and the Virgin Islands). The importance of the peer review findings cannot be overemphasized. Here, we provide you with some recent significant and minor deficiencies that you can keep in mind when planning and staffing your compilation and review engagements.

Significant Deficiencies

.108 Significant deficiencies include matters that normally (1) are material to understanding the financial statements or auditor's or accountant's report or (2) represent a critical auditing or SSARS procedure.² An engagement with a significant deficiency is normally considered substandard. Frequently mentioned significant deficiencies in compilation and review engagements that have been noted in peer review comment letters include, among other matters, the following:

- Reports that include the following:
 - Omissions of required reporting elements of applicable standards
 - Issuance of a review report when the accountant is not independent
 - Failure to disclose lack of independence in a compilation report
 - Failure to disclose the omission of substantially all disclosures
 - Failure to disclose the omission of the statement of cash flows in financial statements prepared in accordance with GAAP
 - Failure to disclose an OCBOA for financial statements compiled without disclosure, where the basis of accounting is not readily determinable from reading the report
 - Failure to disclose, in the accountant's report, a material departure from professional standards (Examples include the nonconsolidation of appropriate subsidiaries with a parent company's financial statements; omission of significant income tax provisions in interim financial statements; omission of significant disclosures related to material defined employee benefit plans; or nonrecognition of significant deferred income.)
- Financial statement measurement, presentation, and disclosure, which includes the following:
 - Inclusion of material balances that are not appropriate for the basis of accounting used
 - Failure to include a material amount or balance necessary for the basis of accounting used (examples include the omission of material accruals, failure to provide for material losses or doubtful accounts, or failure to provide for material deferred income taxes)

² Failure to document the understanding with the entity through the use of an engagement letter, and/or include a reference on each page of the financial statements that they are "restricted for management's use only" as required by SSARS No. 8 or failure to include any one of the required descriptions and statements in the engagement letter will be considered a significant deficiency.

- Significant departures from the financial statement formats prescribed by industry audit and accounting guides
- Omission of significant required disclosures related to material financial statement balances or transactions
- Omission of disclosures of significant accounting policies applied (GAAP or OCBOA)
- Omission of significant matters related to the understanding of the financial statements (the cumulative material effect of a number of disclosure deficiencies)
- Improper accounting of a material transaction (e.g., recording a capital lease as an operating lease)
- Misclassification of a material transaction or balance
- Failure to include a summary of significant assumptions in a financial forecast or projection
- Use of a statement of changes in financial position where a statement of cash flows is appropriate
- Failure to segregate the statement of cash flows into the components of operating, investing, and financing activities SSARS procedures and documentation, which includes failures to:
 - Perform inquiries and analytical procedures in review engagements
 - Document inquiries and analytical procedures in review engagements
 - “Read” compiled financial statements for obvious or material errors
 - Obtain client management representation letters in review engagements

Minor Deficiencies

.109 Minor deficiencies include departures from professional standards that (1) are not normally material to a proper understanding of the financial statements or accompanying auditor’s or accountant’s report or (2) do not represent a critical audit or SSARS procedure. As a result, these departures, by themselves, would not usually cause an engagement to be substandard. Frequently mentioned minor deficiencies, among others, in compilation and review engagements that have been noted in peer review comment letters include the following:

- Reports, including the following:
 - Failure to report on supplementary information
 - Minor departures from standard report language, provided the report is not otherwise misleading about the degree of responsibility taken
 - Failure to reference all time periods encompassed by the financial statements
 - Inclusion of a reference about the omission of the statement of cash flows for financial statements prepared on an OCBOA (A statement of cash flows is not required for financial statements prepared on an OCBOA.)
 - Minor report-dating departures
 - Failure to disclose an OCBOA for financial statements compiled without disclosure where the basis of accounting is otherwise readily determinable from reading the report
 - Omission of a reference to a statement of changes in equity (included with the financial statements)
- Financial statement measurement, presentation, and disclosure, which include the following:
 - Omitted or inadequate disclosures related to minor account balances or transactions (e.g., minor disclosure deficiencies related to accounting policies, inventory, valuation allowances, long-term debt, related-party transactions, concentrations of credit risk, deferred income taxes, or employee benefit plans)

- Minor departures from the financial statement formats recommended by industry audit and accounting guides
- Failure to reference the financial statements to the accountant's report or the accompanying footnotes
- Use of financial statement titles that are not appropriate for the basis of accounting used when the accountant's report, financial statements, or footnotes otherwise indicate the basis of accounting
- Failure to include the title "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Omitted" as appropriate for the presentation of certain selected disclosures
- Failure to accrue income taxes where the accrual and provision are expected to be immaterial to the financial statements taken as a whole
- SSARS procedures and documentation, which include the following:
 - Minor documentation deficiencies related to review engagements
 - Minor omitted procedures related to review engagements

.110 Although there are many recurring deficiencies noted in peer review, you can take steps to avoid them by keeping these common mistakes in mind as you plan and perform future compilation and review engagements.

Accounting Pronouncements and Guidance Update

.111 Presented below is a list of recently issued accounting pronouncements and other guidance issued since the publication of last year's Alert. See the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] for a summary explanation of these issuances. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment to FASB Statement No. 13 and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated with Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions</i>
Statement of Position (SOP) 01-5	<i>Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</i>
SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i>

On the Horizon

.112 You might want to keep abreast of auditing and accounting developments and upcoming guidance that may affect engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS. The AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] summarizes some of the more significant outstanding exposure drafts.

.113 The following table lists the various standard-setting bodies' Web sites where you may obtain information about outstanding exposure drafts. (Also see Appendix B, "The Internet—An Accountant's Research Tool," of this Alert for a more complete list of helpful Web sites.)

Standard Setting Body**Web Site**AICPA Auditing
Standards Board (ASB)www.aicpa.org/members/div/auditstd/drafts.htmAICPA Accounting
Standards Executive
Committee (AcSEC)www.aicpa.org/members/div/acctstd/edo/index.htm

GASB

www.gasb.org

FASB

www.fasb.orgProfessional Ethics
Executive Committeewww.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site at: www.aicpa.org. The AICPA will notify interested parties by e-mail about new exposure drafts. To have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft email list" in the subject header field to help process the submissions more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

AICPA Resource Central

Publications

.114 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements (product numbers appear in parentheses).

- *Revenue Recognition Audit Guide* (012510kk)
- *Analytical Procedures Audit Guide* (012551kk)
- *Auditing Estimates and Other Soft Accounting Information Practice Aid* (010010kk)
- *Accounting Trends & Techniques—2002* (009894kk)
- *Preparing and Reporting on Cash- and Tax-Basis Financial Statements Practice Aid* (006701kk)
- *Understanding and Implementing SSARS No. 8* (006612kk)

Audit and Accounting Manual

.115 The *Audit and Accounting Manual* (005132kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. The manual contains numerous practice aids, samples, and illustrations, including audit programs; auditors' reports; checklists; engagement letters; and management representation and confirmation letters, among other items. The 2002 edition of the manual includes a newly reorganized section addressing compilation and review engagements.

AICPA's reSOURCE Online Accounting and Auditing Literature

.116 Get access—any time, any where—to the AICPA's latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides (more than 20 guides), Audit Risk Alerts (more than 15 alerts) and *Accounting Trends & Techniques*. To subscribe to this essential service for accounting professionals, go to cpa2biz.com.

Educational Courses

.117 The AICPA has developed a number of continuing professional education (CPE) courses that might be valuable to CPAs performing compilation and review engagements. Those courses include (product numbers appear in parentheses):

- Compilation and Review Engagements by Dan M. Guy (73369kk)
- Advanced Update for Compilation and Review Engagements (731500kk)
- Annual Update for Accountants and Auditors (730017kk)

.118 Courses designed with compilation and review in mind include:

- Cash- and Tax-Basis Financial Statements—Preparation and Reporting (CTB)
- Controller by the Hour: Competencies and Controversies (731490kk)
- Workpaper Documentation (732059kk)

Online CPE

.119 The AICPA offers an online learning tool entitled *AICPA InfoBytes*. An annual fee (\$119 for members and \$319 for nonmembers) offers unlimited access to hundreds of hours of CPE content in one- and two-credit courses. Register today as our guest at www.cpa2biz.com/infobytes.

CPE CD-ROM

.120 *The Practitioner's Update* (738452kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

.121 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

AICPA Technical Hotline and Ethics Hotline

.122 Do you have a complex technical question about GAAP, OCBOA, accounting, auditing, compilation engagements, review engagements, or other technical matters? If so, you may use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with their answer. You can reach the Technical Hotline at 888-777-7077.

.123 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

Web Sites³

AICPA Online and cpa2biz

.124 Here is a unique opportunity to stay abreast of matters relevant to the CPA profession! AICPA Online, at aicpa.org, informs you of developments in the accounting and auditing world as well as developments

³ See Appendix B, "The Internet—An Accountant's Research Tool," of this Alert for additional helpful Web sites.

in congressional and political affairs affecting CPAs. In addition, you can visit the Web site cpa2biz.com, which offers you all the latest AICPA products, including more than 15 audit risk alerts, more than 20 audit and accounting guides, the professional standards, and CPE courses.

Test Your Knowledge

.125 After you have read and studied this Alert, find out how well you have mastered the material by completing the test below. For each multiple-choice or true-false question, select the best answer. Correct answers are included at the end of the test.

- _____ 1. The new definition of *submission of financial statements* includes:
 - a. Materially modifying client-prepared financial statements
 - b. Generating financial statements on a computer
 - c. Preparing financial statements either manually or through the use of computer software
 - d. Printing financial statements
- _____ 2. The new type of compilation engagement is for financial statements restricted for:
 - a. Management's use only
 - b. Employee use only
 - c. Internal use only
 - d. Bank use only
- _____ 3. A CPA in public practice who performs *controllership services* for a client does not have to comply with SSARS.
TRUE FALSE
- _____ 4. A CPA must gain an understanding of a client's internal control when performing a review engagement.
TRUE FALSE
- _____ 5. A CPA has a responsibility to plan a compilation engagement to consider the risk of material misstatement that results from fraud.
TRUE FALSE
- _____ 6. A CPA in public practice, who also serves as an officer, director, owner, or employee of an entity:
 - a. May issue financial statements of the entity and comply with SSARS No. 1
 - b. May issue financial statements of the entity and use a transmittal letter that clearly indicates his or her relationship to the entity
 - c. Must comply with SSARS No. 1
 - d. Either a or b
- _____ 7. Written engagement letters are required in bookkeeping engagements.
TRUE FALSE
- _____ 8. Financial statements submitted in conjunction with litigation support services are exempt from SSARS No. 1 if:
 - a. The accountant is an expert witness or a trier of fact.
 - b. The accountant's work is subject to detailed analysis and challenge by each party to the dispute.
 - c. The accountant is engaged by the attorney and is protected by the attorney's work product privilege.
 - d. Any one of the above conditions is met.
- _____ 9. If a CPA is serving as treasurer of a political campaign, he or she has the *option* of complying with SSARS when submitting financial statements of the campaign.
TRUE FALSE

- _____ 10. Statements on Quality Control Standards (SQCS) apply to:
- a. Compilation engagements only
 - b. Review engagements only
 - c. Audit engagements only
 - d. All audit, attest, accounting and review, and other services
- _____ 11. According to the proposed SSARS, *Omnibus—2002*, written representations should be obtained from current management for all periods covered by a review report.
- TRUE FALSE
- _____ 12. A statement of retained earnings is a required financial statement.
- TRUE FALSE
- _____ 13. SSARS No. 1 contains no specific documentation requirements for a compilation engagement.
- TRUE FALSE
- _____ 14. All of the following are required to be documented in a review engagement, except:
- a. Management representation letter
 - b. Engagement letter
 - c. Matters covered in inquiry and analytical procedures
 - d. Unusual matters that were considered and their resolution
- _____ 15. Supplementary information includes:
- a. Consolidating information
 - b. Graphs
 - c. Statistical data
 - d. All of the above
- _____ 16. Disclosure of a change in capital can be made:
- a. In a statement of retained earnings
 - b. In the notes to the financial statements
 - c. On the face of the income statement
 - d. Any of the above
- _____ 17. Which of the following is one of the criteria that must be met in order for financial statements submitted in connection with litigation services to be exempt from SSARS?
- a. The service consists of being an expert witness.
 - b. The services are in connection with a business combination.
 - c. The accountant's work is not subject to analysis and challenge by each party to the dispute.
 - d. All of the above criteria must be met.
- _____ 18. Goodwill may no longer be amortized.
- TRUE FALSE
- _____ 19. Goodwill must be tested for impairment at least annually.
- TRUE FALSE
- _____ 20. Which of the following would be considered a significant deficiency in a peer review?
- a. Failure to use a written engagement letter in a management-use-only compilation
 - b. Failure to include a reference to the restricted nature on each page of the financial statements in a management-use-only compilation
 - c. Failure to include any one of the required descriptions and statements in the engagement letter for a management-use-only compilation
 - d. All of the above

Test Your Knowledge—Answers

.126

1. *c*—The new definition of *submission of financial statements* does not include the terms *generating, modifying, or printing*.
2. *a*—The changes to SSARS No. 1 are very specific in that the financial statements are to be restricted to management's use only—not for employee or internal use.
3. FALSE—If a CPA, in the *practice of public accounting*, submits financial statements to a client or third parties, he or she must comply with SSARS, unless the CPA is an officer, director, employee, or owner of the entity.
4. FALSE—SSARS does not require the accountant to obtain an understanding of the client's internal control when conducting a compilation or review engagement.
5. FALSE—SSARS does not require the accountant to plan or perform a compilation or review engagement to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud.
6. *d*—A CPA in the practice of public accounting who also serves as a stockholder, partner, director, officer, or employee of the entity, may either (1) comply with the requirements of SSARS No. 1, or (2) communicate, preferably in writing, his or her relationship to the entity (for example, stockholder, partner, director, officer, or employee).
7. FALSE—No professional standard requires a written engagement letter for bookkeeping services, but a written engagement letter is highly recommended to reduce the possibility of a misunderstanding about the terms of the engagement.
8. *d*
9. TRUE—A CPA in the practice of public accounting who also serves as treasurer of a political campaign, may either (1) comply with the requirements of SSARS No. 1, or (2) communicate, preferably in writing, his or her relationship to the campaign.
10. *d*
11. TRUE
12. FALSE—APB Opinion No. 12, *Omnibus Opinion—1967*, only requires disclosure of a change in capital.
13. FALSE—Although, generally, SSARS does not require any specific documentation in a compilation engagement, SSARS No. 1 requires that the understanding with the entity (engagement letter) be documented in a management-use-only compilation.
14. *b*—A written engagement letter is not required in a review engagement—only an understanding with the entity—and this understanding does not have to be documented.
15. *d*
16. *d*
17. *a*
18. TRUE—FASB Statement No. 142 does not permit amortization of goodwill.
19. TRUE
20. *d*

.127 This Alert replaces the *Compilation and Review Alert—2001/02*. The *Compilation and Review Alert* is published annually. As you encounter 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 e-mail these comments to lgivarz@aicpa.org or write to:

Leslye Givarz
AICPA
Harborside Financial Center
201 Plaza Three
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Appendix A

Bookkeeping Services—Illustrative Engagement Letter

[Appropriate Salutation]

This letter is to confirm my (our) understanding of the terms and objectives of our engagement and the nature and limitations of the services I (we) will provide. So that I (we) can meet your expectations related to the services I (we will provide, this engagement letter clearly identifies both the services that will be provided and the frequency with which these services will be provided.

I (We) will prepare semimonthly payroll checks and compute required withholdings based on hours worked, rates of pay, tax jurisdictions, and withholding information provided by you or your representative. You will need to review all payroll checks prior to signing them, and notify us promptly of any errors. I (We) will notify you of required payroll tax deposits. Failure to make these deposits on a timely basis will subject you to penalties and interest.

I (We) will prepare quarterly and annual payroll tax returns, as well as your annual 1099 forms. You will need to review the returns prior to signing them, and notify us promptly of any errors or omissions.

Any significant changes in the number of employees, various miscellaneous deductions, or other items involved could cause an increase in my (our) fees. I (We) also require that you provide complete information in good “working order” for me (us), with checks and deposits coded to the proper accounts. I (We) will discuss with you in advance any proposed increase in our fees.

I (We) will also assist you with various bookkeeping functions, including consultation on recordkeeping, recording of transactions, and periodic adjustments, among others.

My (Our) work in connection with this engagement is not intended to result in the submission or issuance of financial statements by [Firm] as defined by Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. A submission of financial statements, as defined by professional standards, requires that the CPA present to a client or third parties financial statements that the CPA has prepared manually or through the use of computer software. By your signature below, you understand that the submission of financial statements as defined above is outside the scope of this engagement.

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

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

I (We) appreciate the opportunity to be of service to you and believe that this letter accurately summarizes the significant terms of our engagement. If you have any questions, please let me (us) know. If the foregoing terms are in accordance with your understanding, please sign the copy of this letter in the space provided and return it to me (us).

Sincerely yours,

[Signature of accountant]

Accepted and agreed to:

XYZ Company

[Title]

[Date]

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Appendix B

The Internet—An Accountant's Research Tool

Here are some useful Web sites that may provide valuable information to accountants doing compilations and reviews.

General Web Sites of Interest

<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	www.aicpa.org
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, practice bulletins containing financial, accounting and reporting recommendations, among other things.	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
The Electronic Accountant	World Wide Web magazine that features up-to-the-minute news for accountants	www.electronicaccountant.com
AuditNet	Electronic communications among audit professionals	www.cowan.edu.au/mra/home.htm
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com
Double Entries	A weekly newsletter on accounting and auditing around the world	www.csu.edu.au/lists.anet/ADBLEL/index.html
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
Federal Reserve Bank of New York	Key interest rates	www.ny.frb.org/pihome/statistics/dlyrates
Cybersolve	Online financial calculators, such as ratio and breakeven analysis	www.cybersolve.com/tools1.html
FedWorld.Gov	U.S. Department of Commerce-sponsored site providing access to government publications	www.fedworld.com
Hoovers Online	Online information on various companies and industries	www.hoovers.com
Ask Jeeves	Search engine that uses a user-friendly question format. Provides simultaneous search results from other search engines as well (e.g., Excite, Yahoo, AltaVista)	www.askjeeves.com

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
Vision Project	Information on the profession's vision project	www.cpavision.org/horizon
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	www.kentis.com/ib.html
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org

In addition to these Web sites, be sure to review those listed in the "On the Horizon" section of this Alert.

AAM Section 8030

Health Care Industry Developments—2002/03

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your health care industry audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the health care industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010]. You should refer to the full text of the accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this Alert.

Economic and Industry Developments

.04 Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), among other matters, provides guidance for auditors regarding the specific procedures that should be considered in planning an audit in accordance with generally accepted auditing standards (GAAS). SAS No. 22 states that the auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics, and consider matters affecting the industry in which the entity operates, including, among other matters, economic conditions as they relate to the specific audit.

Economic Developments

.05 For a thorough discussion of the economic and business environment, see the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

Economic News

.06 Health care organizations operated and invested through the first three quarters of 2002 in an economy recovering from the recession experienced in 2001. The economic word for 2001 was *uncertain* and that continues to hold true for 2002. The current mix of opposing trends—solid demand, but no strong pickup in jobs—stems partly from the nature of this business cycle. In other words, mild recoveries tend to follow mild recessions.

.07 Some matters in the forefront during the first three quarters of 2002 were allegations of fraudulent financial reporting, employee layoffs, increased government regulation and security procedures resulting from terrorism concerns, and weak corporate profits reported in some business sectors. Also, consumer spending has remained strong through the first half and into the third quarter of 2002. Interest rates have

remained low. Following a number of cuts by the Federal Reserve Board in 2001, the federal funds rate stayed at 1.75 percent through much of 2002, until the rate was cut again in November 2002 to 1.25 percent. Activity in the U.S. equities markets through the first three quarters of 2002 was volatile. The Dow Jones Industrial Average, Standard and Poor's 500 Index, and National Association of Securities Dealers Automated Quotation continued their declines of the two previous years.

Third-Party Payers

Federal and State Health Care Programs

.08 Many entities in the health care industry derive their revenues from payment arrangements with third-party payers. These third-party payers frequently include federal and state health care programs. Patient revenues received from these programs continue to be affected by new rules that change the methodologies for determining payments for services and products. These new rules include changes from cost-based reimbursement to prospective payment systems (PPS), as well as changes to fee reimbursement schedules for health care services. The Centers for Medicare and Medicaid Services (CMS) in recent years has published final rules that establish new PPS for Medicare outpatient services, home health care agencies, inpatient rehabilitation facilities, and, most recently, long-term care hospitals. (See the related discussion "Prospective Payment Systems" in the "Regulatory Developments" section of this Alert.)

.09 Auditors of health care organizations that will be affected by new or revised PPS rules may want to consider whether these changes in payment regulations may create any incentive for clients to look for inappropriate methods of maximizing income, and whether management has adopted appropriate revenue recognition policies. Auditors need to pay attention to warning signals that may indicate increased audit risk with respect to revenue recognition and respond with appropriate professional skepticism and additional audit procedures.

.10 Statement of Position (SOP) 00-1, *Auditing Health Care Third-Party Revenues and Related Receivables*, is a source of guidance to auditors of health care organizations regarding uncertainties inherent in health care third-party revenue recognition. This SOP discusses auditing matters to consider in testing third-party revenues and related receivables, and provides guidance regarding the sufficiency of evidential matter and reporting on financial statements of health care organizations exposed to material uncertainties.

Managed Care

.11 The use of managed care organizations as a means of controlling rapidly rising health care costs has slowed. Medicare+Choice plans allow Medicare program beneficiaries to participate in managed care plans. In 2002, a number of Medicare program beneficiaries enrolled in these plans were affected by the decisions of managed care companies to drop their coverage of Medicare plans.

.12 Auditors may need to consider the financial statement impact of new contracts executed between hospitals and other providers of health care services and managed care organizations, and between managed care organizations and members. Chapter 13 in the Audit and Accounting Guide *Health Care Organizations* provides guidance on applying generally accepted accounting principles (GAAP) to providers of prepaid health care services for the accounting and reporting of health care costs, contract losses (premium deficiencies), stop-loss insurance (reinsurance), and contract acquisition costs.

Rising Cost of Health Care Products and Services

.13 The cost of health care in the United States is rising at rates higher than those seen in recent years. Health care organizations are providing expanded and sometimes higher-cost alternatives to existing health care products. Many health care organizations are incurring additional costs for regulatory compliance. The demand for health care products and services, such as prescription drugs and hospital services, remains strong as the baby boomer segment of the U.S. population continues to age.

Information Technology

.14 Health care organizations use information technology (IT) for communicating health information to patients and maintaining patient medical records, among other things. However, for the most part, the health care industry has lagged behind other industries in its use of IT. A number of health care organizations have undertaken projects to expand their use of IT, such as projects involving the transmission of patient billing information electronically, or the electronic maintenance of patient medical records, sometimes for viewing by the patients or by physicians at other locations. When health care organizations undertake certain projects to expand their use of IT, they must consider whether compliance is required with certain regulations. These regulations include the Health Insurance Portability and Accountability Act (HIPAA) Administrative Simplification provision rules for privacy of medical information, and for submitting claims electronically. (See the related discussion “The Health Insurance Portability and Accountability Act of 1996” in the “Regulatory Developments” section of this Alert.)

Staffing

.15 While a number of entities in other industries have reported employee layoffs, the health care industry in general continues to provide job opportunities, as the hiring and retention of staff, in particular, professional nursing staff, continues to be a focus for many health care organizations. Shortages of qualified nursing staff in many areas have resulted in some health care organizations hiring agency nurses to fill vacancies, a practice that can lead to increases in personnel costs. Some health care organizations, however, continue to use staffing cuts as a cost saving measure. Staffing cuts may also result when programs and services are eliminated at the health care organization.

Pension Benefits

.16 Compensation and benefit costs, including pension benefit costs, can be significant to the financial statements of health care organizations. As a result of the sustained downturn in the markets, health care organizations may be reexamining and revising their pension earning assumptions downward. Downward revisions in pension earning assumptions and a resulting increase in pension expense may have a material affect on the health care organization’s operating results, liquidity, or capital resources.

.17 Also, health care organizations may be recording a minimum pension liability for the first time in recent years. As a reminder, paragraph 10.18 in the Audit and Accounting Guide *Health Care Organizations* provides guidance on the items that should be reported separately from the performance indicator in the statement of operations of not-for-profit health care organizations. This includes other items that are required by GAAP to be reported separately, such as minimum pension liabilities in accordance with paragraph 37 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 87, *Employers’ Accounting for Pensions*.

Insurance Coverage

.18 Many health care organizations are facing steep increases in premiums from malpractice or property and casualty insurers, along with more restrictive terms and conditions, and policies that are not renewed. Meanwhile, some insurers have failed in, or withdrawn from, certain market segments, raising concerns about the financial viability of some insurance carriers.

.19 Health care organizations facing premium increases, concerns about the viability of the insurer, or policies that are not renewed, may be reevaluating their insurance coverage. Health care organizations may be opting to increase deductibles in order to reduce costs, or may increase the extent of risk retained as a result of changes in policy terms. There may also be significant changes in assessing the extent of risk retained due to changes in the types of insurance coverage used. Auditors should consider the effect of these insurance coverage issues when conducting audits of health care organizations.

Regulatory Developments¹

.20 This section of the Alert provides brief summaries of some of the regulations issued and regulatory publications released since the writing of last year's Alert that may affect your clients in the health care industry. Brief discussions about certain regulations discussed in last year's Alert that have effective or compliance dates in 2002 or 2003 are also included.

.21 Auditors may need to monitor changes in government regulations for various reasons. For example, new regulations requiring prospective payment systems directly affect the recognition of patient revenues. Also, health care organizations that are providers of services to patients covered under Medicare or other federal health care programs have potential exposure to fines and penalties as a result of laws and regulations governing the billing and cost-reporting process. As another example, auditors of health care organizations may be required to comply with government auditing standards, as specified in the *Government Auditing Standards* (also referred to as the Yellow Book).

.22 As discussed in paragraphs 2.41 and 2.42 of the Audit and Accounting Guide *Health Care Organizations*, there are certain laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in financial statements of health care organizations, including tax laws affecting tax accruals and tax expense, as well as Medicare and Medicaid laws directly affecting the amount of revenue recognized during the accounting period. Other laws and regulations relate more to the health care organization's operating aspects than to its financial and accounting aspects, and the financial statement effect is indirect.

The Health Insurance Portability and Accountability Act of 1996

.23 The Administrative Simplification provisions of HIPAA require the U.S. Department of Health and Human Services (HHS) to adopt national standards for electronic health care transactions; unique identifiers for employers, providers, and health plans; and security and privacy standards for health information. Health care organizations are implementing final rules that HHS has issued to address certain Administrative Simplification provisions.

.24 Additional information on HIPAA is available on the HHS Web site, www.hhs.gov. Also, see the related discussion "Implementing Health Insurance Portability and Accountability Act Requirements" in the "Audit Issues and Developments" section of this Alert.

Standards for Privacy of Individually Identifiable Health Information

.25 As discussed in last year's Alert, HHS published a final rule with standards for privacy of individually identifiable health information. This rule applies to health plans, health care clearinghouses, and those health care providers that conduct certain financial and administrative transactions electronically (covered entities). This rule's "Business Associates" section includes guidance for a covered entity's responsibilities when engaging others to perform essential functions or services for them. Health plans other than small health plans, health care clearinghouses, and health care providers who conduct certain financial and administrative transactions electronically have until April 14, 2003, to comply. Small health plans have until April 14, 2004, to comply. The final rule was published in the December 28, 2000, *Federal Register*.

.26 Also, in the August 14, 2002, *Federal Register*, HHS published modifications to the privacy regulations. Among the modifications, covered entities (except for small health plans) are given up to an additional year

¹ Readers should be alert for updates, amendments, or other changes to the rules discussed in this section of the Alert and other recent developments related to regulatory activities. The brief summaries provided in this section of the Alert are for informational purposes only. Readers should refer to the full text of the regulations and other documents that are discussed in this section of the Alert. See the "Information Sources" section at the end of this Alert for a list of some Web sites that can provide additional information on regulatory issues and developments.

to change existing written contracts to comply with the rule's business associates requirements. HHS also provided sample business associate contract provisions.

Standards for Electronic Transactions

.27 Also discussed in last year's Alert was the HHS rule that established standard data content and formats for submitting electronic claims and other administrative health transactions. The final rule, published in the August 17, 2000, *Federal Register*, contains the requirements concerning the use of these standards by private and government sector health plans, health care clearinghouses, and certain health care providers. Small health plans have until October 16, 2003, to comply. Health plans other than small health plans, health care clearinghouses, and health care providers that choose to transmit their transactions in electronic form, were required to comply no later than October 16, 2002. In December 2001, however, Congress adopted legislation allowing most covered entities to obtain an extension of one year, to October 16, 2003, to comply with the standards.

Employer Identifier

.28 HHS issued a final rule, published in the May 31, 2002, *Federal Register*, that adopts the employer identification number issued by the Internal Revenue Service (IRS) as the National Employer Identifier in the health care industry. In general, covered entities have until July 30, 2004, to comply. Small health plans have until August 1, 2005, to comply.

Prospective Payment Systems

Inpatient Rehabilitation Facilities

.29 As discussed in last year's Alert, the CMS final rule for inpatient rehabilitation facility PPS was published in the August 7, 2001, *Federal Register*. The inpatient rehabilitation facility PPS replaces an existing cost-based payment system. Among the principal features of this PPS, rehabilitation facilities are to be paid for Medicare patients on a per-discharge basis, similar to acute care hospitals. This PPS rule took effect for inpatient rehabilitation facilities with cost reporting periods beginning on January 1, 2002.

.30 Inpatient rehabilitation facilities could elect how they will transition into the PPS over a one-year period, either by being paid based on a blended rate, consisting of a mix of the rates paid under the old and new systems, or by being paid at full PPS rates.

Long-Term Care Hospitals

.31 The CMS final rule for long-term care hospitals PPS was published in the August 30, 2002, *Federal Register*. The long-term care hospitals PPS replaces the existing cost-based payment system. Among the features of this PPS, long-term care hospitals are to be paid for Medicare patients at a per-discharge amount. Long-term care hospitals are defined as having an average inpatient length of stay greater than 25 days. A five-year transition period has been implemented to phase-in this PPS for long-term care hospitals. The long-term care hospital may elect to exercise a one-time opportunity to be paid based on 100 percent of the federal rate for cost reporting periods beginning on or after October 1, 2002.

Physicians' Referrals to Health Care Entities With Which They Have Financial Relationships

.32 As discussed in last year's Alert, CMS published a final rule entitled "Medicare and Medicaid Programs; Physicians' Referrals to Health Care Entities With Which They Have Financial Relationships" in the January 4, 2001, *Federal Register*. This rule was effective January 4, 2002. In the December 3, 2001, *Federal Register*, CMS published an interim final rule with comment period that delays for one year, until January 6,

2003, the effective date of the last sentence of Section 411.354(d)(1) of the final rule. In the November 22, 2002, *Federal Register*, CMS published a final rule that further postpones, for an additional six months, until July 7, 2003, the effective date of the last sentence of Section 411.354(d)(1).

Corporate Compliance

.33 Compliance plans are voluntary for health care organizations unless imposed under a corporate integrity agreement by the HHS Office of Inspector General (OIG). The OIG has issued compliance program guidance in previous years for:

- Clinical laboratories
- Hospitals
- Home health agencies
- Third-party medical billing companies
- Hospices
- The durable medical equipment, prosthetics, orthotics, and supply industry
- Medicare+Choice organizations
- Nursing facilities
- Individual and small group physician practices

In 2002, the OIG released “Draft Compliance Program Guidance for Ambulance Suppliers,” “Draft Compliance Program Guidance for Pharmaceutical Manufacturers,” and “Solicitation of Information and Recommendations for Revising the Compliance Program Guidance for the Hospital Industry.” You can get these releases and the full text of the OIG compliance program guidance, as well as information on any compliance guidance issued subsequent to the writing of this Alert, on the OIG Web site, www.oig.hhs.gov/.

Circular A-133 Audit Guidance Update

2002 Compliance Supplement Issued

.34 The Office of Management and Budget (OMB) Circular A-133 *Compliance Supplement* (the Supplement) is based on the requirements of the Single Audit Act Amendments of 1996 and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133). Those requirements provide for the issuance of a compliance supplement to assist auditors in planning and performing the required audits. The Supplement identifies 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, and use of the Supplement is mandatory.

.35 The OMB issued its 2002 Supplement in March 2002. The 2002 Supplement is effective for audits of fiscal years beginning after June 30, 2001. Appendix V of the Supplement lists changes from the 2001 Supplement.

Circular A-133 Audit Reviews

.36 To obtain more information about the Circular A-133 audits of the grants they administer, many federal OIGs and state-level agencies with oversight responsibilities for Circular A-133 audits are increasing their scrutiny of completed audits through desk reviews, quality control reviews, and other types of examinations. Those reviews and peer reviews of single audit engagements have identified a range of audit problems.

.37 The AICPA has published a new Audit Risk Alert, *Single Audits—2002* [AAM section 8220], as a complement to SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.² This new Audit Risk Alert is intended to provide auditors of organizations receiving federal awards with an overview of recent industry, regulatory, and professional developments that may affect the audits they perform. Among other things, it includes a discussion of common engagement deficiencies noted in peer reviews and ethics investigations, a summary of audit deficiencies found by various federal agency OIGs, audit refresher information on determining major programs and auditors' responsibility for internal control, and the latest on Federal Audit Clearinghouse data collection form submissions.

Government Auditing Standards

.38 The Government Accounting Office (GAO) 1994 *Government Auditing Standards* (GAS) or Yellow Book, as amended, is the set of standards for audits you should follow when so required by law, regulation, agreement, contract, or policy. The Yellow Book standards are an integral part of the requirements for a Circular A-133 audit.

Help Desk—The Yellow Book documents discussed in this section are available on the GAO's Web site at www.gao.gov/govaud/ybk01.htm.

Independence Requirements

.39 In January 2002, the GAO made significant changes to the Yellow Book's auditor independence requirements. Amendment No. 3, *Independence*, establishes independence standards for CPAs, non-CPAs, government auditors, and performance auditors. It deals with a range of auditor independence issues, including restrictions on nonaudit services. It affects a significant number of audits, applying to auditors of federal, state, and local governments as well as not-for-profit and for-profit recipients of federal (and some state) grants and loans.

.40 **Topics Addressed.** Amendment No. 3 addresses when auditors and their organizations are independent from the organizations they audit by defining when personal, external, and organizational impairments to independence exist. The amendment applies not only to auditors but also to specialists—such as actuaries, appraisers, and attorneys—whose work is used in an audit and which the amendment defines as members of the audit team. If an audit organization is not independent, the amendment states that the auditor should (1) decline to perform the work or (2) report the impairment in the scope section of the auditor's report when a government auditor cannot decline to perform the work because of a legislative requirement or for other reasons.

.41 Like the AICPA's Code of Professional Conduct, Amendment No. 3 adopts an engagement-team-focused approach to independence for matters such as financial interests of an individual auditor. It requires that audit organizations' internal quality control systems identify impairments to independence and determine compliance with Yellow Book independence requirements. Amendment No. 3 provides criteria for when governmental audit organizations are organizationally independent from the audited entity for purposes of external and internal reporting, expanding the previous criteria for when such organizations are independent for external reporting purposes.

.42 Amendment No. 3 employs a principles-based approach to independence supplemented with certain safeguards for matters such as the performance of nonaudit services. With respect to nonaudit services, the Yellow Book rule is more restrictive than the AICPA rule because it prohibits an auditor from providing nonaudit services (except for routine advice or activities) when those services are significant or material to

² Statement of Position (SOP) 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, is updated annually with conforming changes. SOP 98-3 is available in the AICPA publication *Technical Practice Aids*, and is also included as an appendix to the Audit and Accounting Guides *Audits of State and Local Governmental Units* (Non-GASB 34 Edition), *Audits of State and Local Governments* (GASB 34 Edition), and *Not-for-Profit Organizations*.

the subject matter of the audit. When the nonaudit service is not significant or material to the subject matter of the audit, specific safeguards are required, including a requirement for a separate engagement team to perform the service. The amendment's provisions relating to nonaudit services have the potential to significantly change auditor-client relationships.

.43 The standard for nonaudit services employs two overarching principles:

1. Audit organizations should not provide nonaudit services that involve performing management functions or making management decisions; and
2. Audit organizations should not audit their own work or provide nonaudit services in situations where the nonaudit services are significant or material to the subject matter of the audits.

.44 Audit organizations may perform nonaudit services that do not violate the above principles only if all of the following seven safeguards are followed:

1. The audit organization should preclude personnel who provided the nonaudit services from planning, conducting, or reviewing audit work related to the nonaudit service.
2. The audit organization is precluded from reducing the scope and extent of the audit work beyond the level that would be appropriate if another unrelated party performed the nonaudit work.
3. The audit organization should document its consideration of the nonaudit service, and document its rationale that providing the nonaudit service does not violate the two overarching principles.
4. Before performing nonaudit services, the audit organization should establish and document an understanding with the audited entity regarding the objectives, scope of work, and product or deliverables of the nonaudit service. The audit organization should also establish and document an understanding with management that management is responsible for the substantive outcomes of the work.
5. The audit organization's quality control systems for compliance with independence requirements should include policies and procedures to assure consideration of the effect on the ongoing, planned, and future audits when deciding whether to provide nonaudit services and a requirement to have the understanding with management of the audited entity documented. The understanding should be communicated to management in writing. Documentation must specify management's responsibility for the nonaudit service, management's qualifications to conduct the required oversight, and that management's responsibilities were performed.
6. In cases where certain nonaudit services by their nature impair the audit organization's ability to meet either or both of the overarching principles for certain types of audit work, the audit organization should communicate to management of the audited entity, before performing the nonaudit service, that the audit organization would not be able to perform subsequent audit work related to the subject matter of the nonaudit service.
7. For audits selected in the peer review, all related nonaudit services should be identified to the audit organization's peer reviewer and the audit documentation made available for peer review.

Help Desk—The AICPA has developed a fact sheet on Amendment No. 3 that discusses its provisions, including nonaudit services that may be performed and those that are expressly prohibited. In addition, the AICPA has developed a comparison of the AICPA and Yellow Book independence requirements. Both those documents, which are on the AICPA Web site at www.aicpa.org/members/div/ethics/index.htm, explain the differences between the Yellow Book and the AICPA independence requirements in general and for the following nonaudit services: bookkeeping, payroll, tax, human resources, information technology, appraisal or valuation, indirect cost proposal or cost allocation plans, legislative and administrative decision-making, internal control self-assessments, and assisting legislative bodies.

.45 The GAO has released additional guidance on the auditor independence requirements under GAS. *Government Auditing Standards—Answers to Independence Standard Questions* is available on the GAO Web site at www.gao.gov/govaud/ybk01.htm. Also, in that guidance, the GAO extended the effective date of Amendment 3 from all Yellow Book audits for periods beginning on or after October 1, 2002, to all Yellow Book audits for periods beginning on or after January 1, 2003.

Proposed 2002 Revision to Government Auditing Standards

.46 In January 2002 the GAO issued an exposure draft, *Government Auditing Standards: 2002 Revision*. The exposure draft proposes revisions to all chapters of the Yellow Book, including those relating to both financial and performance audits. The exposure draft does not address auditor independence (which was recently addressed in Amendment No. 3, discussed earlier in this section of the Alert). Among other matters, the proposed revisions are intended to clarify the types of audits and services that are performed under the Yellow Book, to strengthen and streamline certain provisions of it, and to improve understandability of the GAS. As of the writing of this Alert, the GAO staff is estimating a spring 2003 issuance date for a final document.

Internal Revenue Service Developments

Intermediate Sanctions—Final Regulations

.47 The IRS has issued final regulations for intermediate sanctions designed to protect donors and charities from insider dealing and excessive compensation for executives. The rules gave the IRS a tool to regulate the activities of exempt organizations, with or without revoking the organization's exempt status. The temporary rules were discussed in last year's Alert. The final regulations differ slightly from the temporary rules. The effective and applicability dates of the final regulations are January 23, 2002.

.48 Not-for-profit organizations must continue to document how and why they compensate CFOs, CEOs, or others with significant power over an organization. The law not only targets top executives but also their family members and family-controlled entities in which there is a combined ownership interest of more than 35 percent if any receives excess benefits. Penalties will be imposed on any transaction that provides excess economic benefits to a disqualified person (that is, a person in a position to exercise substantial power over the affairs of a public charity or social welfare organization). Penalties will also be imposed on transactions involving excessive compensation for executives. The ultimate penalty is revocation of the not-for-profit organization exempt status.

.49 There is a five-year look-back period starting with the transaction date. This means that the IRS can look back five years from the date the executive received the excess benefit and impose the tax if he or she was a disqualified person at any time during this period. A parallel five-year look-back rule applies in determining qualifying organizations. If an entity was a section 501(c)(3) or 501(c)(4) organization at any time within the five years before the transaction date, section 4958(e) considers it a qualifying organization.

.50 **Exceptions.** There are several exceptions to the section 4958 rules, including a binding contract exception as well as an initial contract exception.

.51 **Donor-Advised Funds.** The final regulations do not adopt a special rule regarding any donor or adviser to a donor-advised fund; consequently, the general rule will apply to determine whether a donor is a disqualified person.

.52 **Managers Shield Expanded.** An excise tax equal to 10 percent of the excess benefit may be imposed on the participation of an organization manager in an excess benefit transaction between an applicable tax-exempt organization and a disqualified person. This tax, which may not exceed \$10,000 with respect to any single transaction, is only imposed if the 25 percent tax is imposed on the disqualified person, the organization manager knowingly participated in the transaction, and the manager's participation was willful

and not the result of reasonable cause. There is also joint and several liability on this tax. A person may be liable for both the tax paid by the disqualified person and this organization manager tax in appropriate circumstances.

.53 The final regulations add to the means by which organization managers can protect themselves from such tax. Protection starts with making a decision as to whether an individual is an organization manager. An organization manager is any officer, director, or trustee of an applicable tax-exempt organization, or any individual having powers or responsibilities similar to those of the officers, directors, or trustees of the organization, regardless of title. An organization manager is not considered to have participated in an excess benefit transaction if the manager has opposed the transaction in a manner consistent with the fulfillment of the manager's responsibilities to the organization. For example, a director who votes against giving an excess benefit would ordinarily not be subject to this tax.

.54 A manager's participation in a transaction will not be considered knowing whether the organization's board has satisfied the requirements of the rebuttable presumption of reasonableness for the transaction as discussed in the final regulations. A manager is protected as well if he or she relies on a professional's reasoned written opinion on matters within the professional's expertise that concludes, based on a full disclosure of all the facts, that an excess benefit transaction has not occurred.

.55 *Disregarded Benefits Rule Broadened.* This rule addresses the final regulations added to the economic benefits, which are to be disregarded in determining whether an excess benefit transaction has occurred, including employee expense reimbursements paid under an accountable plan. A plan is an accountable plan if (a) the reimbursement is for ordinary and necessary business expenses; (b) the employee substantiates the expenses reimbursed within a reasonable period of time; and (c) the employee must return the unsubstantiated portion of the reimbursement.

.56 *Section 4958 Does Not Replace Revocation of Exemption.* Section 4958 does not affect the substantive standards for tax exemption under sections 501(c)(3) and 501(c)(4), including the requirements that the organization be organized and operated exclusively for exempt purposes, and that no part of its net earnings inure to the benefit of any private shareholder or individual. In most cases, the imposition of this intermediate sanction will be in lieu of revocation. The IRS has indicated that the following four factors will be considered in determining whether to revoke an applicable tax-exempt organization's exemption status if an excess benefit transaction has occurred. The four factors are:

1. Whether the organization has been involved in repeat excess benefit transactions.
2. The size and scope of the excess benefit transaction.
3. Whether, after concluding that it has been party to an excess benefit transaction, the organization has implemented safeguards to prevent future recurrences.
4. Whether there was compliance with other applicable laws.

.57 *Rebuttable Presumption Procedure.* The regulations contain a procedure for ensuring that all top officials are in full compliance, and thus not liable for the taxes. The procedure is called creating a "rebuttable presumption of reasonableness." The procedure is *not required*, but is potentially advantageous to all persons covered by the regulations.

Acquisition Financing Bond Transactions

.58 Auditors of health care organization clients that may have or may be contemplating acquisition financing bond transactions involving hospital mergers should note that in April 2002, the IRS published proposed regulations regarding the issuance of such debt. Simultaneously with the publication of the proposed rules, the IRS released a separate voluntary settlement agreement that would allow systems that have already merged using acquisition financing debt that is deemed not to be in compliance with the tax code to repay a percentage of their arbitrage profits and avoid having their bonds declared taxable.

Audit Issues and Developments³

The Sarbanes-Oxley Act of 2002

.59 The Sarbanes-Oxley Act of 2002, signed into law on July 30, 2002, is the most significant legislation affecting the accounting profession since 1933. A more detailed discussion of the Sarbanes-Oxley Act of 2002 can be found in the general *Audit Risk Alert—2002/03* [AAM section 8010]. Also, the AICPA has a new hotline to help members with questions about the Sarbanes-Oxley Act of 2002, how it will be implemented, and how to comply. Call (866) 265-1977. The hotline will remain in operation for the remainder of 2002.

Implementing Health Insurance Portability and Accountability Act Requirements

.60 A number of health care organizations will be focusing on implementing HHS rules that address the Administrative Simplification provisions of HIPAA. (See the related discussion “The Health Insurance Portability and Accountability Act of 1996” in the “Regulatory Developments” section of this Alert.) Compliance with these rules will require a multiyear effort with the potential for significant resource outlays, including major changes for processing. Noncompliance with HIPAA Administrative Simplification provision rules can subject affected health care organizations to civil and criminal penalties. Also, health care organizations that are unable to comply with the required deadlines for submission of electronic claims in the HIPAA required format may find such claims rejected by third-party payers.

.61 Health care organizations may have implemented, and may be continuing to implement, system changes necessary to accommodate the Administrative Simplification provision rules. Auditors should be alert for risks relevant to financial reporting that can arise or change due to, for example, new systems or system changes. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance on the independent auditor’s consideration of an entity’s internal control in an audit of financial statements in accordance with GAAS. SAS No. 55, as amended, among other matters, states that risks relevant to financial reporting include internal and external events and circumstances that may occur and adversely affect an entity’s ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Risks can arise or change due to circumstances, such as, among other things, changes in the regulatory or operating environment and new or revamped information systems.

.62 Auditors of a health care organization should consider their client’s preparations for compliance with the HIPAA Administrative Simplification provision rules and be alert for any conditions or events which, when considered in the aggregate, indicate there could be substantial doubt about the client’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 significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in conjunction with others. See the discussion “Going Concern Considerations” in this section of the Alert for a discussion about the guidance in 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).

.63 Implementing regulations such as the rules issued to address the HIPAA Administrative Simplification provisions may result in increases in certain expense categories. The auditor should consider this when designing and performing analytical procedures in financial statement audits conducted in accordance with GAAS. SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329) provides guidance on the use of analytical procedures.

.64 Also, the AICPA has published a technical practice aid (TPA) that provides nonauthoritative guidance on accounting by health care organizations for costs associated with upgrading and improving

³ Readers should refer to the full text of the laws, regulations, auditing and accounting standards, and other pronouncements that are discussed in this section of the Audit Risk Alert.

computer systems to comply with HIPAA. See the discussion “Accounting for Computer Systems Costs Incurred in Connection With the Health Insurance Portability and Accountability Act of 1996” in the “New Accounting Pronouncements and Other Guidance” section of this Alert.

.65 As noted previously in the discussion “Standards for Privacy of Individually Identifiable Health Information” in the “Regulatory Developments” section of this Alert, HHS published a final rule with standards for privacy of individually identifiable health information. This rule’s “Business Associates” section includes guidance for a covered entity’s responsibilities when engaging others to perform essential functions or services. Covered entities are required to execute agreements with business associates to ensure the business associates protect the privacy of health information. Auditors of health care organizations that are covered entities may be considered business associates.

.66 Auditors should consider the effect of the final rule and the rule’s business associates provisions on the audit. For example, SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) states that the auditor should prepare and maintain audit documentation, the form and content of which should be designed to meet the circumstances of the particular audit engagement. The quantity, type, and content of audit documentation are matters of the auditor’s professional judgment. If the health care organization client refuses to share information with its auditor due to concerns over violating privacy regulations, the auditor should consider whether the inability to obtain information as a result of the refusal by the client constitutes a scope limitation on the audit. As discussed in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), as amended, restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the inability to obtain sufficient competent evidential matter, may require the auditor to qualify his or her opinion or to disclaim an opinion. In such instances, the reasons for the auditor’s qualification of opinion or disclaimer of opinion should be described in the report.

Auditing and Accounting Guidance for Investments

.67 Health care organizations, like organizations in other industries, have been investing in markets and in a business environment that during the past year have seen periods of significant volatility, declines in corporate profitability, and ratings downgrades for a number of companies. Auditors should consider whether their health care organization clients may have invested in debt or equity instruments of companies that have potential for declines in value, including an other than temporary decline in value.

Not-for-Profit Health Care Organizations

.68 Not-for-profit health care organizations should consider the guidance in FASB Statement No. 124, *Accounting for Certain Investments in Held by Not-for-Profit Organizations*. FASB Statement No. 124 requires that investments in equity securities with readily determinable fair values and all investments in debt securities be reported at fair value with gains and losses included in a statement of activities. FASB Statement No. 124 does not include within its scope investments in equity securities that are accounted for under the equity method, investments in consolidated subsidiaries, or investments in derivative instruments that are subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. FASB Statement No. 124 also includes disclosure requirements.

.69 Chapter 4 in the Audit and Accounting Guide *Health Care Organizations* also includes guidance about the reporting of investments by not-for-profit health care organizations, including the classification of investment return. A discussion of some of the guidance presented in chapter 4 follows.

.70 Investment return (including realized and unrealized gains and losses) not restricted by donors or by law should be classified as changes in unrestricted net assets as follows:

- Included in the performance indicator:

- Dividend, interest, and other similar investment income
- Realized gains and losses
- Unrealized gains and losses on trading securities⁴
- Other than temporary impairment losses
- Excluded from the performance indicator:
 - Unrealized gains and losses on other than trading securities

.71 You can find a discussion about the performance indicator in the section “Financial Statement Presentation” in chapter 10 of the Guide.

.72 Gains and investment income that are limited to specific uses by donor-imposed restrictions may be reported as increases in unrestricted net assets if the restrictions are met in the same reporting period as the gains and income are recognized, provided that the organization has a similar policy for reporting contributions received, applies the policy consistently from period to period, and discloses its accounting policy. The classification of these gains and investment income in unrestricted net assets should be consistent with the preceding paragraph.

.73 In the absence of donor stipulations or law to the contrary, losses on the investments of a donor-restricted endowment fund shall reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before the loss occurs. Any remaining loss shall reduce unrestricted net assets and shall be excluded from the determination of the performance indicator. If losses reduce the assets of a donor-restricted endowment fund below the level required by the donor stipulations or law, gains that restore the fair value of the assets of the endowment fund to the required level shall be classified as increases in unrestricted net assets and shall be excluded from the determination of the performance indicator.

.74 Except as described in the two preceding paragraphs, investment return (including realized and unrealized gains and losses) restricted by donors or by law, should be classified as changes in temporarily or permanently restricted net assets consistent with the applicable restrictions.

Investor-Owned Health Care Organizations

.75 Investor-owned health care organizations are subject to the accounting, reporting, and disclosure requirements of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. FASB Statement No. 115 defines three categories into which an enterprise classifies investments:

- *Held-to-maturity.* These investments are reported at amortized cost.
- *Trading securities.* These investments are reported at fair value, with unrealized holding gains and losses included in income.
- *Available-for-sale.* These investments are reported at fair value with unrealized holding gains and losses excluded from income and reported in a separate component of other comprehensive income until realized, except all or a portion of the unrealized holding gain and loss of an available-for-sale security that is designated as being hedged in a fair value hedge shall be recognized in earnings during the period of the hedge.

.76 FASB Statement No. 115 also states that for individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost

⁴ Trading securities are defined in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, including any interpretations thereof.

basis is other than temporary. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value.

.77 Appendix B, “Additional Guidance on Impairment of Securities,” of the FASB Special Report *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities*, includes the Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 59, *Accounting for Noncurrent Marketable Equity Securities*. SAB No. 59 provides examples of factors that, individually or in combination, indicate that a decline is other than temporary and that a write-down of the carrying value is required. These factors are:

- The length of time and the extent to which the market value has been less than cost.
- The financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential.
- The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

.78 Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, provides that declines in the value of investments that are accounted for using the equity method be recognized if the declines in value are other than temporary.⁵

.79 Also, see chapter 4 of the Audit and Accounting Guide *Health Care Organizations* for further discussion about the accounting and reporting requirements for investments.

Auditing Guidance

.80 Audit guidance for auditing investments is available in SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), and in the Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

.81 SAS No. 92 includes a discussion of impairment losses that states that determinations of whether losses are other than temporary often involve estimating the outcome of future events. Accordingly, judgment is required in determining whether factors exist that indicate that an impairment loss has been incurred at the end of the reporting period. These judgments are based on subjective as well as objective factors, including knowledge and experience about past and current events and assumptions about future events. The following are examples of such factors:

- Fair value is significantly below cost and:
 - The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
 - The decline has existed for an extended period of time.
 - Management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.

⁵ See paragraph 1.30 and Appendix A to chapter 1 of the Audit and Accounting Guide *Health Care Organizations* for information about the applicability of APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, as amended, to not-for-profit organizations.

- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

.82 Subsequent to the balance sheet date but prior to the issuance of the financial statements, an event may occur (for example, further decline in fair value, or ratings downgrade) that would provide evidence a decline in fair value is other than temporary. Auditors should refer to SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560), for guidance on auditor's procedures relating to subsequent events. Two types of subsequent events require consideration by management of the health care organization and evaluation by the independent auditor: an event that provides additional evidence with respect to conditions that existed at the date of the balance sheet being reported on, or an event that provides evidence with respect to conditions that did not exist at the date of the balance sheet being reported on but arose subsequent to that date. If the event provides additional evidence with respect to the investment being other than temporarily impaired at the balance-sheet date, the financial statements should be adjusted. If the event provides evidence that the investment was not other than temporarily impaired at the date of the balance sheet being reported on but arose subsequent to that date, the health care organization needs to consider whether the event may be of such a nature that disclosure of the event is required to keep the financial statements from being misleading.

.83 Auditors should also consider the need for using the work of a specialist for valuation of complex financial instruments. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), can be useful in providing guidance to auditors who use the work of a specialist in performing an audit in accordance with GAAS.

Going Concern Considerations

.84 Remember to consider the guidance in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. Among other matters, SAS No. 59 provides guidance on (1) the auditor's evaluation of whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements that are being audited, (2) the adequacy of financial statement disclosure, and (3) the need to modify the auditor's report. SAS No. 59 states that continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. Ordinarily, information that 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.

.85 As discussed in SAS No. 59, the auditor may identify information about certain conditions or 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 significance of such conditions and events will depend on the circumstances, and some may have significance only when viewed in connection with others. SAS No. 59 provides the following examples of such conditions and events:

- Negative trends (for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, and adverse key financial ratios).
- Other indications of possible financial difficulties (examples include the need to seek new sources or methods of financing or to dispose of substantial assets).
- Internal matters (examples include the need to significantly revise operations).
- External matters that have occurred (examples include legal proceedings, legislation, or similar matters that might jeopardize an entity's ability to operate).

.86 For audits of financial statements for periods beginning on or after May 15, 2002, you will also need to consider the guidance in SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 341). Early implementation of this SAS is permitted. SAS No. 96, among other matters, amends SAS No. 59 to require an auditor to document:

- The conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern.
- The work performed in connection with the auditor's evaluation of management's plans.
- The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated.
- The consideration and effect of that conclusion on the financial statements, disclosures, and audit report.

Auditor Responsibility Concerning Illegal Acts

.87 Auditors of health care organizations should be aware of the requirements of SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). SAS No. 54 prescribes the nature and extent of the consideration that the auditor should give to the possibility of illegal acts by a client in audits of financial statements in accordance with GAAS. The term *illegal acts* refers to violations of laws or governmental regulations. SAS No. 54 states, in part, that 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. Entities may be affected by many other laws or regulations relating more to an entity's operating aspects than to its financial and accounting aspects, and their financial statement effect is indirect. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. SAS No. 54 also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

.88 Among other matters, SAS No. 54 provides guidance regarding communications with audit committees and others. SAS No. 54 notes that the auditor should be assured that the audit committee, or others with equivalent authority and responsibility, is adequately informed with respect to illegal acts that come to the auditor's attention.

Fraud

.89 Recent highly publicized instances of fraudulent financial reporting serve as reminders to auditors of the need to remain alert to possible instances of fraudulent activity and to maintain an appropriate attitude of professional skepticism.

.90 Auditors should consider the guidance in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). SAS No. 99 supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316A), and amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230), and SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333). SAS No. 99 does not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02).⁶ However, SAS No. 99 establishes standards and provides

⁶ The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). 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 (see SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, AICPA, *Professional Standards*, vol. 1, AU sec. 312) or fraud.

additional guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.

.91 SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.

.92 A more detailed discussion of SAS No. 99 can be found in the general *Audit Risk Alert—2002/03* [AAM section 8010]. Also, the AICPA has developed a Practice Aid, *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*. For more information about this Practice Aid, see the discussion “On the Bookshelf” in the “Resource Central” section of this Alert.

.93 The AICPA has launched a new, comprehensive Antifraud and Corporate Responsibility Program. The program includes many initiatives, including the new auditing standard, SAS No. 99; the Institute for Fraud Studies; corporate training programs; and new continuing professional education (CPE) recommendations, among others. Information about the program, a list of initiatives, and other fraud resources are now available on the AICPA Web site at www.aicpa.org/antifraud/homepage.htm. Also, look for the AICPA’s Antifraud Resource Center, which will launch on the AICPA Web site, www.aicpa.org, and will offer comprehensive tools, resources, and information for fraud prevention, detection, and deterrence.

2002 Audit and Accounting Guide Health Care Organizations

.94 The Audit and Accounting Guide *Health Care Organizations* is being updated with conforming changes to reflect the issuance of authoritative pronouncements. The Guide is expected to be issued in early 2003.

.95 Among conforming changes planned for the 2002 edition of the Guide are updates for accounting pronouncements FASB Statement No. 141, *Business Combinations*, FASB Statement No. 142, *Goodwill and Other Intangible Assets*, and FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Updates to the Guide for auditing pronouncements include conforming changes for SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, and SAS No. 94, *The Effect of Information Technology on the Auditor’s Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

.96 Conforming changes are also planned for the issuance of GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, and related pronouncements. Because of the phased in effective dates of GASB Statement No. 34, conforming changes planned do not modify the chapters and illustrative financial statements for a governmental hospital authority in Appendix A to the Guide. A new appendix is planned for the Guide that would provide guidance on the requirements of GASB Statement No. 34 and related pronouncements concerning governmental health care entities that are included in the scope of the Guide.

Auditor Association With Municipal Securities Disclosure Documents

.97 The new Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)* expands its discussion about situations in which an auditor becomes associated with an official statement or other offering document for the issuance of municipal securities and, thus, when the auditor should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550). (See further discussion about the new Guide, “Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*,” in the “New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance” section of this Alert.) Paragraph 16.06 in this Guide states that the auditor becomes associated with the official statement in any of the following situations:

- Assisting in preparing the financial information included in the official statement.
- Reviewing a draft of the official statement at the government’s request.

- Manually signing the independent auditor's report included in the official statement.
- Providing a revised independent auditor's report for inclusion in a specific official statement.
- Issuing a comfort letter, the letter described in SAS No. 72, *Letters to Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634.09), as amended, or an attestation engagement report in lieu of a comfort or similar letter on information included in the official statement.
- Providing written agreement for the use of the independent auditor's report in the official statement.
- Issuing a report on an attestation engagement relating to the debt offering (the new Guide includes a discussion on attestation engagements related to the issuance of municipal securities in paragraph 16.20).

.98 Additional information about these seven situations is included in the new Guide. As discussed in paragraphs 16.07 and 16.10 of the Guide, if the auditor is associated with an official statement the guidance in SAS No. 8 provides that the auditor has no obligation to perform any procedures to corroborate other information contained in those documents. However, the auditor should read the other information and consider whether that information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. SAS No. 8 (AU sec. 550.04-.06) provides guidance if the auditor concludes there is a material inconsistency or a material misstatement of fact that is not a material inconsistency. Although an auditor is not required to become associated with a government's official statements except in the situations described in paragraph 16.06 of the Guide, some auditors include a provision in the engagement letter requiring the government to obtain permission from the auditor before using the independent auditor's report in the official statement. Such a provision establishes a requirement that the auditor become associated with the government's official statements when the government requests the required permission from the auditor.

.99 In a November 1994 amendment to rule 15c2-12, the SEC required municipal securities dealers to contract with issuers of municipal bonds for them to provide continuing disclosures at certain times for the life of the bond issue. (See the related discussion "Municipal Securities Disclosures" in the "New Accounting Pronouncements and Other Guidance" section of this Alert). Continuing disclosure, or secondary market disclosure requirements, are made by issuers providing to nationally recognized municipal securities information repositories and state information repositories annual continuing disclosure documents and material events notices. Material events notices are required for 11 specific events, such as principal and interest payment delinquencies and nonpayment-related defaults. Material event notices are provided through a press release or other written notification on an "as needed" basis and do not involve financial statements.

.100 Paragraph 16.09 in the new Audit and Accounting Guide *Audits of State and Local Governments* (GASB 34 Edition) states that the auditor is not required to participate in, or undertake any procedures with respect to a government's continuing disclosure documents, even though they may include audited financial statements. A government's continuing disclosures are not required to be submitted to or disseminated from the distributing organizations as a single document. Thus, an auditor's association with other information encompassed by such disclosures cannot be clearly established. Therefore, the provisions of SAS No. 8 do not apply to documents that contain those disclosures. Any attention the auditor devotes to other information included with audited financial statements in continuing disclosure documents at the government's request should be considered a consulting engagement under the provisions of the AICPA Statement on Standards for Consulting Services No. 1, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*, vol. 2, CS sec. 100). (See further discussion about the new Guide in "Audit and Accounting Guide *Audits of State and Local Governments* (GASB 34 Edition)" in the "New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance" section of this Alert.)

New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance

.101 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the writing of last year's Alert. The AICPA general *Audit Risk Alert*—2002/03 [AAM section 8010] contains a summary explanation of all these issuances. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, the *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards Team and available at www.aicpa.org.

SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i> Issued in June 2002. This SAS is effective for written reports issued or oral advice provided on or after June 30, 2002. Earlier application is permitted.
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i> Issued in September 2002. This SAS amends a number of SASs. The effective dates vary for the amendments.
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i> Issued in October 2002. This SAS is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.
SAS No. 100	<i>Interim Financial Information</i> Issued in November 2002. This SAS is effective for interim periods within fiscal years beginning after December 15, 2002. Early application of the provisions of the SAS is permitted.
SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i> Issued in May 2002. This SOP is effective upon issuance and is applicable only to agreed-upon procedures engagements that report on annual claims prompt payment reports as required by the New Jersey Administrative Code.
Statement on Standards for Attestation Engagements (SSAE) No. 11	<i>Attest Documentation</i> Issued in January 2002. This SSAE is effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002. Earlier application is permitted.
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i> Issued in September 2002. This SSAE is effective upon issuance.
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i> Issued in September 2002. The new Guide is effective for audits of a state or local government's financial statements for the first fiscal period ending after June 15, 2003, in which the government does apply or is required to apply the provisions of GASB Statement No. 34, <i>Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments</i> , or GASB Statement No. 35, <i>Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities</i> .
Audit Guide	<i>Service Organizations: Applying SAS No. 70, as Amended</i> New edition as of April 15, 2002.

(continued)

Audit Interpretations of SAS No. 70, <i>Service Organizations</i>	Interpretation No. 4, "Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls"
	Interpretation No. 5, "Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods"
	Interpretation No. 6, "Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor's Engagement" ⁷
	Published in the February 2002 <i>Journal of Accountancy</i> . Audit interpretations are effective upon publication in the <i>Journal of Accountancy</i> .
Audit Interpretations of SAS No. 58, <i>Reports on Audited Financial Statements</i>	Interpretation No. 14, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing"
	Published in the March 2002 <i>Journal of Accountancy</i> .
	Interpretation No. 15, "Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations"
	Published in the November 2002 <i>Journal of Accountancy</i> .
	Audit interpretations are effective upon publication in the <i>Journal of Accountancy</i> .
Audit Interpretation of SAS No. 1, section 420, <i>Consistency of Application of Generally Accepted Accounting Principles</i>	Interpretation No. 12, "The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Change in the Year of Adoption"
	Published in April 2002 <i>Journal of Accountancy</i> . Audit interpretations are effective upon publication in the <i>Journal of Accountancy</i> .
Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Practice Alert 02-1	<i>Communications with the Securities and Exchange Commission</i>
Practice Alert 02-2	<i>Use of Specialists</i>
Practice Alert 02-3	<i>Reauditing Financial Statements</i>
Statement on Quality Control Standards No. 6	<i>Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>
Practice Aid	<i>Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide</i>
Practice Aid	<i>New Standards, New Services: Implementing Attestation Standards</i>
Practice Aid	<i>Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users</i>

Of the pronouncements, guides, and other guidance listed above, those having particular significance to the health care industry are briefly explained below. These summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

⁷ SAS No. 98, *Omnibus Statement on Auditing Standards—2002*, among other matters, amends SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324). The amendment revises the guidance in Interpretation No. 6, "Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor's Engagement" of SAS No. 70, rescinds Interpretation No. 6, and brings the guidance from Interpretation No. 6 into SAS No. 70. This amendment is effective for reports issued on or after January 1, 2003.

Auditing Standards

SAS No. 98, Omnibus Statement on Auditing Standards—2002

.102 Footnote 7 in this Alert discusses the amendment of SAS No. 70 by SAS No. 98. SAS No. 98 also amends a number of other accounting standards. Three of the amendments are discussed here:

- SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551.12 and .15). SAS No. 98 amends SAS No. 29 to clarify the reporting guidance with respect to required supplementary information presented in an auditor-submitted document. SAS No. 29, as amended by SAS No. 98, states that when supplementary information required by GAAP is presented outside the basic financial statements in an auditor-submitted document, the auditor should (a) express an opinion on the information if the auditor has been engaged to examine the information, (b) report on the information using the guidance in AU sections 551.12 and 551.14, provided such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, or (c) disclaim an opinion on the information. This amendment was effective upon issuance of SAS No. 98.
- SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550.07). The amendment clarifies that an auditor may issue a report providing an opinion, in relation to the basic financial statements taken as a whole, on other information that has been subjected to the auditing procedures applied in the audit of those basic financial statements. This amendment was effective upon issuance of SAS No. 98.
- SAS No. 52, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558.08 and .10). The amendments to SAS No. 52 clarify that an auditor may issue a report providing an opinion, in relation to the basic financial statements taken as a whole, on supplementary information that has been subjected to the auditing procedures applied in the audit of those basic financial statements. This amendment was effective upon issuance of SAS No. 98.

Audit and Accounting Guides—Industry Guides and General Guides

Audit and Accounting Guide Audits of State and Local Governments (GASB 34 Edition)

.103 The AICPA issued a new Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)* (product no. 012662kk). Even though the AICPA has issued this new Guide, it has also retained and continued to conform the 1994 edition of the Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)* as well (product no. 012562kk). The most significant issue addressed in the new Guide is materiality determinations for purposes of planning, performing, evaluating the results of, and reporting on the audit of financial statements.

.104 The scope of the new Guide applies to all state and local governmental entities, including hospitals and other health care providers, even though the audits of those entities may also be subject to the guidance in the Audit and Accounting Guide *Health Care Organizations*. Therefore, the new Guide requires auditors of those governmental health care organizations that are included in the scope of the Audit and Accounting Guide *Health Care Organizations* to also consult the new Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*. Paragraphs 1.21 and 12.13 of the new Guide explain how auditors should use the auditing guidance in both of the Guides that apply to those entities.

General Audit and Accounting Guide Service Organizations: Applying SAS No. 70, as Amended

.105 Health care organizations may use service organizations, such as bank trust departments, service centers, billing entities, or employee benefit plan administrators. SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, 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, as well as guidance for independent auditors who issue reports on the processing of transactions by service organizations for use by other auditors.

.106 The Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (new edition as of April 15, 2002) (product no. 012772kk) assists auditors in applying GAAS in audits of financial statements of entities that use service organizations, and in service auditors' engagements. Chapter 1 of this Audit Guide, "Audit Considerations for an Entity That Uses a Service Organization," identifies the information a user auditor may need about the processing performed by a service organization for a user organization, and also describes how a user auditor obtains that information. Other chapters in the Guide include discussions about the form and content of service auditors' reports, and guidance to user auditors on using a service auditor's report on controls placed in operation (type 1 report) and a service auditor's report on controls placed in operation and tests of operating effectiveness (type 2 report), among other matters. Also, AU section 324 is reproduced as Appendix F to this Audit Guide, and AU section 9324: *Service Organizations: Auditing Interpretations of Section 324* is reproduced in Appendix G to this Audit Guide. Appendix G also includes the three new interpretations of SAS No. 70 listed earlier in this section of the Alert.

New Accounting Pronouncements and Other Guidance

AICPA and FASB Pronouncements

.107 Presented below is a list of accounting pronouncements and other guidance issued since the writing of last year's Alert. The AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] contains a summary explanation of all these issuances. These summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site, www.aicpa.org, and the FASB Web site, www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy*.

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| FASB Statement No. 145 | <i>Rescission of FASB Statements No. 4, 44, 64, Amendment of FASB Statement No. 13, and Technical Corrections</i>
Issued in April 2002. The provisions of this Statement related to the rescission of FASB Statement No. 4, <i>Reporting Gains and Losses from Extinguishment of Debt</i> , shall be applied in fiscal years beginning after May 15, 2002, with early application encouraged. The provisions of paragraphs 8 and 9(c) of this Statement related to FASB Statement No. 13, <i>Accounting for Leases</i> , are effective for transactions occurring after May 15, 2002, with early application encouraged. All other provisions of this Statement are effective for financial statements issued on or after May 15, 2002, with early application encouraged. |
| FASB Statement No. 146 | <i>Accounting for Costs Associated With Exit or Disposal Activities</i>
Issued in June 2002. The provisions of this Statement are effective for exit or disposal activities initiated after December 31, 2002. Early application is encouraged. |
| FASB Statement No. 147 | <i>Acquisitions of Certain Financial Institutions</i>
Issued in October 2002. See paragraph 7 of this Statement for effective date information. |
| FASB Interpretation No. 45 | <i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i>
Issued in November 2002. The initial recognition and initial measurement provisions apply on a prospective basis to guarantees issued or modified after December 31, 2002, regardless of the guarantor's fiscal year end. The disclosure requirements in the Interpretation are effective for financial statements of interim or annual periods ending after December 15, 2002. |

SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i> Issued in December 2001. Changes in accounting and financial reporting required by this SOP should be applied prospectively and are effective for annual and interim financial statements issued for fiscal years beginning after December 15, 2001, with certain exceptions. Early application is encouraged.
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i> See the “New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance” section of this Alert for more information.
Technical Practice Aids	<i>Software Revenue Recognition</i>
Questions and Answers	<i>FASB Statement No. 87, Employers’ Accounting for Pensions</i>

FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*

.108 FASB Statement No. 141, *Business Combinations*, addresses financial accounting and reporting for business combinations. FASB Statement No. 141, however, does not apply to certain business combinations, including a business combination involving two or more not-for-profit organizations, or the acquisition of a for-profit business by a not-for-profit organization.

.109 The provisions of FASB Statement No. 141 and FASB Statement No. 142, *Goodwill and Other Intangible Assets*, should not be applied to goodwill and intangible assets arising from a combination between two or more not-for-profit organizations or acquired in the acquisition of a for-profit business entity by a not-for-profit organization until the FASB completes its project on those types of combinations and acquisitions. Thus, the guidance in APB Opinion No. 16, *Business Combinations*, and APB Opinion No. 17, *Intangible Assets*, remains in effect for such assets. In addition, when applying APB Opinion Nos. 16 and 17, not-for-profit organizations should continue to apply the amendments to those Opinions found in other literature even though that other literature may have been superseded by FASB Statement Nos. 141, 142, and 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. For example, when applying APB Opinion No. 17, not-for-profit organizations should continue to apply the amendments to that Opinion found in FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, even though that Statement was superseded by FASB Statement No. 144. Readers should be alert to the issuance of a final standard on combinations of not-for-profit organizations. See the related discussion “Combinations of Not-for-Profit Organizations” in the “On the Horizon” section of this Alert.

Elimination of the Temporary Control Exception to Consolidation

.110 FASB Statement No. 144, among other matters, amends Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. AICPA staff and FASB staff are currently considering the guidance in paragraphs 11.10 through 11.12 and paragraph 11.36 in the Audit and Accounting Guide *Health Care Organizations* in light of the elimination of the temporary control exception.

Securities Lending Transactions

.111 Health care organizations that make use of securities lending agreements may not have appropriately accounted for these agreements. Paragraphs 91 through 95 in Appendix A of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provide implementation guidance for securities lending transactions. FASB Statement No. 140 applies not only to financial institutions, but to entities in other industries as well, including the health care industry. FASB Statement No. 140 does not exempt not-for-profit organizations from its scope.

GASB Pronouncements and Other Accounting Guidance for Governmental Health Care Organizations

.112 One statement was issued by the GASB since the writing of last year's Alert. A brief summary of that statement follows, along with a discussion about implementation guidance for GASB Statement No. 34. For information on GASB accounting standards, including any standards that may be issued subsequent to the writing of this Alert, please refer to the GASB Web site, www.gasb.org.

GASB Statement No. 39, Determining Whether Certain Organizations Are Component Units, an amendment of GASB Statement No. 14

.113 The GASB issued GASB Statement No. 39 in May 2002. GASB Statement No. 39 amends GASB Statement No. 14, *The Financial Reporting Entity*, to provide additional guidance to determine whether certain organizations, such as not-for-profit foundations, for which the primary government is not financially accountable, should be reported as component units based on the nature and significance of their relationship with the primary government.

.114 Organizations that are legally separate, tax-exempt entities and that meet all of the following criteria should be discretely presented as component units:⁸

- The economic resources received or held by the separate organization are entirely or almost entirely for the direct benefit of the primary government, its component units, or its constituents.
- The primary government, or its component units, is entitled to, or has the ability to otherwise access, a majority of the economic resources received or held by the separate organization.
- The economic resources received or held by an individual organization that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.

.115 This Statement continues the requirement in GASB Statement No. 14 to apply professional judgment to determine whether the relationship between a primary government and other organizations for which the primary government is not financially accountable, and that do not meet the criteria in GASB Statement No. 39, is such that exclusion of the organization would make the reporting entity's financial statements misleading or incomplete. Those component units should be reported based on the existing blending and discrete presentation display requirements of GASB Statement No. 14.

.116 The provisions of GASB Statement No. 39 are effective for financial statements for periods beginning after June 15, 2003. Earlier application is encouraged.

.117 Appendix C of GASB Statement No. 39 provides nonauthoritative illustrative examples intended to illustrate how the criteria in paragraph 5 of the Statement would be applied in several hypothetical situations. Illustrative Example 7 discusses a hospital foundation.

GASB Statement No. 34 Implementation Guidance

.118 The GASB Web site, www.gasb.org, has an area devoted to the implementation of GASB Statement No. 34. Also, the GASB staff issued a question and answer book in December 2001, *Guide to Implementation of GASB Statement 34 and Related Pronouncements*.

.119 See the related discussion "2002 Audit and Accounting Guide *Health Care Organizations*" in the "Audit Issues and Developments" section of this Alert about the 2002 conforming changes resulting from

⁸ These criteria are discussed in paragraph 5 of Governmental Accounting Standards Board (GASB) Statement No. 39, *Determining Whether Certain Organizations Are Component Units*. See the GASB Web site, www.gasb.org, for information regarding the error correction of paragraph 5.

the issuance of GASB Statement No. 34 and related pronouncements. Also, for information about a new edition of an industry audit guide for state and local governments that reflects the guidance in GASB Statement No. 34, see the discussion “Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*” in the “New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance” section of this Alert.

.120 In addition, the AICPA has issued a revised edition of its nonauthoritative question-and-answer booklet on GASB Statement No. 34, *Understanding and Implementing GASB’s New Financial Reporting Model: A Question and Answer Guide for Preparers and Auditors of State and Local Governmental Financial Statements* (product no. 022516kk). The booklet provides a complete, yet uncomplicated, explanation of the standards for the new financial reporting model.

Technical Practice Aids⁹

Accounting for Computer Systems Costs Incurred in Connection With the Health Insurance Portability and Accountability Act of 1996

.121 The AICPA Accounting Standards staff, helped by industry experts, released the following question and answer (Q&A), commonly referred to as Technical Practice Aid (TPA), on accounting for computer systems costs incurred in connection with the HIPAA.

Inquiry—The Health Insurance Portability and Accountability Act of 1996 (HIPAA) was enacted by the federal government with the intent to assure health insurance portability, improve the efficiency and effectiveness of the health care system, reduce health care fraud and abuse, help ensure security and privacy of health information, and enforce standards for transacting health information. HIPAA addresses issues of security and confidentiality in the transfer of electronic patient information and facilitates the reduction of administrative costs by standardizing health care electronic transactions. How should health care organizations account for computer systems costs incurred in connection with HIPAA?

Reply—Costs associated with upgrading and improving computer systems to comply with HIPAA should follow the guidance set forth in SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. The accounting for specific compliance costs depends on whether the costs relate to “upgrades and enhancements” or maintenance. The following summarizes the financial reporting requirements for each type of cost:

Upgrades and enhancements are defined in SOP 98-1 as “modifications to enable the software to perform tasks that it was previously incapable of performing.” In order for upgrades and enhancements to internal-use software to be capitalized, “it must be probable that those expenditures will result in additional functionality.” For example, if the changes increase the security of the data from tampering or alteration or reduce the ability of unauthorized persons to gain access to the data, those changes would be tasks that the software previously could not perform and the associated qualifying costs of application development stage activities should be capitalized. Conversely, if the changes merely reconfigure existing data to conform to the HIPAA standard or regulatory requirements, such changes would not result in the capability to perform of additional tasks and the associated costs therewith should be expensed as incurred. Because many of the costs associated with HIPAA relate to compliance with the Act and do not result in “additional functionality,” those costs should be expensed as incurred.

⁹ Section 6400 in the “Technical Questions and Answers” section of *Technical Practice Aids* includes questions and answers (Q&A) specifically pertaining to health care organizations. The Q&A are nonauthoritative, and are based on selected practice matters identified by the staff of the AICPA Technical Hotline and various other bodies within the AICPA. As of the writing of this Alert, the Q&A discussed in this section of the Alert is also available on the AICPA Web site at www.aicpa.org.

Maintenance costs should be expensed as incurred. Training costs and data conversion costs, except for costs to develop or obtain software that allows for access or conversion of old data by new systems, should also be expensed as incurred.

Reporting the Costs of Soliciting Contributed Services

.122 The Accounting Standards Executive Committee (AcSEC) developed a prospectus for a proposed SOP to address questions that arose about reporting costs of soliciting contributed services that do not meet the recognition criteria for contributions in FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*. At its March 27, 2002, meeting, the FASB objected to AcSEC's undertaking a project to address this issue. The FASB believes a project is not necessary to clarify the existing GAAP that addresses this issue. The FASB believes that paragraphs 26 through 28 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, require that information about expenses be reported by functional classification and that fund-raising activities include soliciting contributions of services from individuals, regardless of whether those services meet the recognition criteria for contributions in FASB Statement No. 116. The FASB also observed that the definition of *fund-raising activities* in paragraph 13.35 of the Audit and Accounting Guide *Not-for-Profit Organizations* conforms to paragraphs 26 through 28 of FASB Statement No. 117 and provides that costs of soliciting donors to contribute services (time) should be reported as fund-raising activities regardless of whether those services meet the recognition criteria for contributions in FASB Statement No. 116. (The FASB observed that that conclusion is also articulated in the March 2000 AICPA Technical Practice Aid No. 6140.11, *Costs of Soliciting Contributed Services and Time That Do Not Meet the Recognition Criteria in FASB Statement No. 116*.)¹⁰

Embedded Derivatives: Application of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to a Not-for-Profit Organization's Obligation Arising From a Split-Interest Agreement

.123 In April 2002, the FASB's Derivatives Implementation Group issued implementation guidance Issue No. B35, *Embedded Derivatives: Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from an Irrevocable Split-Interest Agreement*. That implementation guidance supersedes certain guidance in Chapter 6, "Split-Interest Agreements," of the Audit and Accounting Guide *Not-for-Profit Organizations* regarding measurement of the liability for unitrusts (split-interest agreements with variable payments) with either period-certain payments or period-certain-plus-life-contingent payments. Specifically, the implementation guidance requires that that liability be measured at fair value; thus, in circumstances in which the fair value is measured using present value calculations, the discount rate assumptions should be revised at each measurement date to reflect current market conditions. A copy of the implementation guidance is included in the Audit and Accounting Guide *Not-for-Profit Organizations* as Appendix B to Chapter 6, and can also be obtained on the FASB Web site, www.fasb.org. The effective date of the implementation guidance is the first day of the first fiscal year beginning after June 15, 2002.

SEC Developments

Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases

.124 The SEC issued Financial Reporting Release (FRR) No. 59, *Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases* (Release No. 33-8039), in December 2001 to caution public companies on their use of pro forma financial information and to alert investors to the potential dangers of such information.

¹⁰ The Q&A included in the "Technical Questions and Answers" section, commonly referred to as Technical Practice Aids, are nonauthoritative, and are based on selected practice matters identified by the staff of the AICPA Technical Hotline and various other bodies within the AICPA.

Cautionary Advice Regarding Disclosure About Critical Accounting Policies

.125 The SEC issued FRR No. 60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (Release No. 33-8040), in December 2001 to remind management, auditors, audit committees, and their advisers that were undertaking the preparation and filing of required annual reports of public companies that the selection and application of the company's accounting policies must be appropriately reasoned. The Cautionary Advice encouraged public companies to include in Management's Discussion and Analysis (MD&A) full explanations, in plain English, of their "critical accounting policies," the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations

.126 The SEC issued FRR No. 61, *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations* (Release No. 33-8056), in January 2002 to set forth certain views of the SEC regarding disclosure that should be considered by registrants in MD&A of financial condition and results of operations while preparing 2001 annual reports. The Statement addresses disclosure matters concerning (1) liquidity and capital resources, including off-balance sheet arrangements, (2) certain trading activities that include non-exchange traded contracts accounted for at fair value, and (3) effects of transactions with related and certain other parties.

Certification of Disclosure in Companies' Quarterly and Annual Reports

.127 In August 2002, the SEC adopted rules (see Release No. 33-8124) to implement the certification mandated by Section 302 of the Sarbanes-Oxley Act of 2002. The new rules require an issuer's principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, each to certify the financial and other information contained in the issuer's quarterly and annual reports. The rules also require these officers to certify that they are responsible for establishing, maintaining, and regularly evaluating the effectiveness of the issuer's internal controls; they have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and they have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation. The SEC also adopted previously proposed rules that require issuers to maintain, and regularly evaluate the effectiveness of, disclosure controls and procedures designed to ensure that the information required in reports filed under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported on a timely basis. Effective date: August 29, 2002.

.128 See the related discussion "The Sarbanes-Oxley Act of 2002" in the "Audit Issues and Developments" section of this Alert.

Municipal Securities Disclosures

.129 As discussed in last year's Alert, issuers of municipal bonds, including not-for-profit health care organizations that are conduit issuers of municipal bonds, are exempt from the registration and reporting requirements of the federal securities laws. However, they are not exempt from the antifraud provisions of the federal securities laws, which forbid making misleading statements in, or omitting material facts from, disclosures made in official statements and annual financial filings and other statements speaking to the market. Briefly, the antifraud provisions apply to a municipal issuer whenever it releases information to the public that is reasonably expected to reach investors and the trading markets. If a statement is made reaching markets or investors, the antifraud provisions apply, regardless of whether the statement is made on paper or delivered electronically. The SEC Interpretive Release *Use of Electronic Media* provides interpretive guidance to corporate and municipal issuers on how securities fraud laws apply to such matters as the electronic delivery of documents and electronic disclosures.

.130 The principal sources of SEC guidance on the operation of the municipal disclosure framework and application of the antifraud provisions are (1) SEC releases, including the March 1994 SEC Interpretive Release No. 34-33741, *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*, and SEC Release No. 34-34961, *Secondary Market Disclosure*, an amendment to Rule 15c2-12 issued in November 1994; and (2) SEC enforcement actions in the municipal sector involving the antifraud provisions. As of the writing of this Alert, there were no recent releases from the SEC relating to the municipal securities market.

.131 For additional information on the SEC and municipal securities developments, see the SEC Web site, www.sec.gov. This site includes a page providing a shortcut to information on the SEC Web site for municipal issuers and other participants in the municipal securities markets.

.132 See a related discussion “Auditor Association With Municipal Securities Disclosure Documents” in the “Audit Issues and Developments” section of this Alert.

National Federation of Municipal Analysts Recommended Best Practices

.133 In October 2002, the National Federation of Municipal Analysts (NFMA) released “Recommended Best Practices in Disclosure for Long-Term Care/Senior Living Debt.” Specific recommendations for the long-term care/senior living sector are split into three different areas: continuing care retirement communities, assisted living facilities, and skilled nursing facilities. The recommended best practices are available on the NFMA Web site, www.nfma.org.

On the Horizon

.134 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] summarizes some of the more significant ongoing projects and exposure drafts outstanding. Presented below is brief information about certain ongoing projects and exposure drafts that are especially relevant to the health care industry. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.135 The following table lists the various standard-setting bodies’ Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed below and in the general *Audit Risk Alert—2002/03* [AAM section 8010]. Readers should refer to information provided by the various standard-setting bodies for further information.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board	www.fasb.org
Governmental Accounting Standards Board	www.gasb.org/tech/techpg.html
Professional Ethics Executive Committee	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA’s standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate “exposure draft e-mail list” in the subject header field to help process the submission more efficiently. Include your full name, mailing address and, if available, your membership and subscriber number in the message.

Combinations of Not-for-Profit Organizations

.136 In November 1999, the FASB affirmed its earlier decision to undertake a project on combinations of not-for-profit organizations separate from its business combinations project. As a result of this decision, FASB Statement No. 141, *Business Combinations*, excludes combinations between two or more not-for-profit organizations, and acquisitions of a for-profit business entity by a not-for-profit organization from its scope. Also, FASB agreed to delay the effective date of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, as it applies to goodwill and other intangible assets arising from combinations between not-for-profit organizations or acquired in the acquisition of a for-profit business entity by a not-for-profit organization until the FASB completes its project on those types of combinations and acquisitions.

.137 The scope of the project on combinations of not-for-profit organizations includes:

- Combinations between two or more not-for-profit organizations.
- Acquisition of a for-profit business enterprise by a not-for-profit organization. The acquisition of a not-for-profit organization by a business enterprise is within the scope of FASB Statement No. 141.

.138 You can obtain additional information about the status of this project on the FASB Web site, www.fasb.org. Also, see the related discussion “FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*” in the “New Accounting Pronouncements and Other Guidance” section of this Alert.

Exposure Draft on Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator

.139 In June 2002, AcSEC released an exposure draft of a proposed SOP, *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator*. The proposed SOP would amend the Audit and Accounting Guide *Health Care Organizations* to address how nongovernmental not-for-profit health care organizations should report gains or losses on hedging and nonhedging derivative instruments under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, and clarify certain matters with respect to the performance indicator (earnings measure) reported by such organizations. Under the proposed SOP, not-for-profit health care organizations would exclude from the performance indicator the effective portion of changes in derivatives accounted for as cash flow hedges. The ineffective portion of changes in the fair value of cash flow hedges, changes in the fair value of derivative instruments that do not qualify for hedge accounting, and changes in the fair value of derivatives that are fair value hedges would be included in the performance indicator.

.140 The proposed SOP would amend paragraphs 10.17 and 10.18 of the Audit and Accounting Guide *Health Care Organizations*. The amendments to the Guide clarify that the performance indicator reported by not-for-profit health care organizations is analogous to income from continuing operations of a for-profit enterprise.

.141 The comment period for the exposure draft ended on August 13, 2002. At its September 2002 meeting, AcSEC approved a final SOP, subject to the chair’s clearance and FASB clearance, that includes changes to the exposure draft provisions. The major changes to the exposure draft are to:

1. Encourage early adoption.
2. Not require pro-forma disclosure of how the current year would have been reported if presented on a basis consistent with the prior years.

.142 In November 2002, the FASB met with representatives of AcSEC and discussed the clearance of a final SOP. The FASB did not object to the issuance of the final SOP, subject to certain changes being made. A final SOP is expected in the fourth quarter of 2002.

Exposure Drafts on Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment

.143 AcSEC released an exposure draft of a proposed SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*. The proposed SOP would apply to all nongovernmental entities, including not-for-profit organizations and regulated entities. Among other matters, this proposed SOP would amend the Audit and Accounting Guide *Health Care Organizations* as follows:

- Replace the third sentence of paragraph 14.33 with the following:
However, costs of acquiring initial continuing-care contracts that are within the scope of SOP 02-X, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, should be expensed or capitalized in accordance with that SOP.
- Delete the last sentence of paragraph 14.33.
- Replace footnote 2 to paragraph 14.33 with the following:
Although SOP 90-8, *Financial Accounting and Reporting by Continuing Care Retirement Communities*, is superseded with the issuance of this Audit and Accounting Guide, its provisions have been adopted in this chapter.
- Delete the second sentence of the "Property and equipment" paragraph of footnote 2 in the Sample Not-for-Profit Health Maintenance Organization illustrative financial statements.

.144 Concurrent with the issuance of this exposure draft, the FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment*.

Potential Technical Practice Aids¹¹

.145 The AICPA is considering addressing issues related to FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*, in a series of Q&As, commonly referred to as TPAs. A number of these potential TPAs are health care specific.

Exposure Draft on Deposit and Investment Risk Disclosures

.146 The GASB published an exposure draft of a proposed statement, *Deposit and Investment Risk Disclosures*, that would amend GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements) and Reverse Repurchase Agreements*. Among the proposed statement's requirements, financial statement disclosures would cover deposit and investment risks; credit risk disclosures would include credit quality information issued by rating agencies; interest rate disclosures would include investment maturity information; disclosures for investments highly sensitive to changes in interest rates would indicate basis for sensitivity; and deposit and investment policies related to disclosed risks would be disclosed.

¹¹ See footnote 9.

New Framework for the Audit Process

.147 The ASB has released an exposure draft of seven proposed SASs relating to the auditor's risk assessment process. See the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] for a discussion of these proposed SASs.

.148 You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained from the AICPA Web site at www.aicpa.org.

Resource Central

Education courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

Checklist and Illustrative Financial Statements for Health Care Organizations

.149 The *Checklist and Illustrative Financial Statements for Health Care Organizations* (product no. 008787kk) is a nonauthoritative financial accounting and reporting practice aid for preparers or reviewers of financial statements of health care organizations.

Audit and Accounting Manual

.150 The *Audit and Accounting Manual* (product no. 005132kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditors' reports; checklists; and engagement letters, management representation letters, and confirmation letters.

Understanding and Implementing GASB's New Financial Reporting Model: A Question and Answer Guide for Preparers and Auditors of State and Local Governmental Financial Statements (Revised Edition)

.151 The AICPA has issued a revised edition of its nonauthoritative question-and-answer booklet on GASB Statement No. 34 (product no. 022516kk). The booklet provides a complete, yet uncomplicated, explanation of the standards for the new financial reporting model.

Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations (Second Edition)

.152 This Practice Aid (product no. 006607kk) provides comprehensive guidance on applying OMB Circular A-133. The publication includes audit checklists and illustrative examples to help auditors perform audits that comply with regulations.

Practice Aid Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide

.153 In connection with the issuance of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, the AICPA has developed a new Practice Aid (product no. 006613kk). The Practice Aid includes topics such as:

- How the new SAS changes audit practice
- Developing an implementation plan

- Audit issues in revenue recognition
- Inquiries of entity personnel
- Practice aids such as:
 - Specialized industry fraud factors, including the health care industry
 - Common frauds, and extended audit procedures

AICPA reSOURCE

.154 AICPA reSOURCE Online is an electronic library that provides instant access to the AICPA's *Professional Standards*, *Technical Practice Aids*, current Audit and Accounting Guides, current Audit Risk Alerts, and *Accounting Trends & Techniques*. To subscribe, go online at www.cpa2biz.com.

.155 The AICPA also has a CD-ROM product titled *reSOURCE: AICPA's Accounting and Auditing Literature*. This CD-ROM also enables subscription access to the AICPA Professional Literature products in a Windows format.

Education Courses

.156 The AICPA has developed a number of CPE courses that are valuable to CPAs working in the health care industry, many of them available for both group study and self-study. For more information about AICPA CPE courses, call the AICPA (Member Satisfaction) at (888) 777-7077.

Online CPE

.157 The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee provides you with unlimited access to hundreds of courses of online CPE in one- and two-hour segments.

CPE CD-ROM

.158 *The Practitioner's Update* (product no. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

.159 To order AICPA products, receive information about AICPA activities, and find help on your membership questions call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.160 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.161 Members of the AICPA Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Web Sites

AICPA Online and CPA2Biz

.162 AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, cpa2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the professional standards, and CPE courses.

Other Helpful Web Sites

.163 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the "Information Sources" table at the end of this Alert.

.164 This Audit Risk Alert replaces the *Health Care Industry Developments—2001/02* Audit Risk Alert. The *Health Care 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 appreciated. You may e-mail these comments to mkasica@aicpa.org or write to:

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Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

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Information Sources

<i>Organization</i>	<i>Web Site</i>
American Institute of Certified Public Accountants Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 Telephone: (888) 777-7077 (Member Satisfaction Center)	www.aicpa.org
Centers for Medicare and Medicaid Services	www.cms.gov
Financial Accounting Standards Board Order Department: 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Telephone: (800) 748-0659	www.fasb.org
General Accounting Office	www.gao.gov
Governmental Accounting Standards Board Order Department: 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Telephone: (800) 748-0659	www.gasb.org
Internal Revenue Service	www.irs.gov
Municipal Securities Rulemaking Board	www.msrb.org
National Federation of Municipal Analysts	www.nfma.org
U.S. Department of Health and Human Services	www.hhs.gov
U.S. Office of Management and Budget	www.omb.gov
U.S. Securities and Exchange Commission	www.sec.gov

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AAM Section 8040

Insurance Industry Developments—2002/03

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your insurance audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business environment in which your clients operate. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the insurance industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

Industry and Economic Developments

The U.S. Economy

.04 Since the beginning of 2002, overall economic activity has been expanding at a moderate pace, showing signs of improvement since the events of September 11. Third-quarter economic growth expanded at a strong 4 percent rate. Still, the Federal Reserve officially said the economy is moving "towards weakness" rather than staying "neutral" and a fourth quarter interest rate cut of 50 basis points was made to stimulate the economy. The Department of Commerce has made extensive revisions to 2001 data, most notably indicating that the 2001 recession was longer and deeper than previously thought.

.05 In 2002, widespread corporate accounting fraud allegations caused ongoing turmoil in U.S. equity markets, including a stock market slide and eroding consumer and investor confidence. Since insurers' investment portfolios consist mainly of fixed-income investments, the low interest rate environment has caused returns on these investments to be bleak. Corporate bonds, yielding a higher return in exchange for slightly higher risk relative to government bonds, are even more risky in the wake of several investigations surrounding accounting procedures and reporting in the corporate arena. Insurance companies must be selective in investing in corporate bonds, and be aware of any potential corporate investigations.

The Aftermath of September 11 on the Insurance Industry

.06 It was just over a year ago when the horrific attacks occurred on September 11, 2001. This one catastrophe affected many lines of business in the insurance industry, including disability, workers' compensation, group life, aviation, and commercial property. The industry, which was experiencing poor underwriting results at the time of the September 11 event, has responded a year later by raising prices and by examining risks as it has never done before.

Increase in Premium Rates

.07 Despite huge losses related to the events surrounding September 11, the insurance industry has managed to partially recover. The industry's improved health is largely attributed to an increase in demand for insurance coverage and subsequent increases in premium rates; allowing companies to both post solid underwriting results and establish high written premiums.

.08 It is hard to determine how the events of September 11 alone affected pricing—the industry had been experiencing years of soft-market pricing; insurers and reinsurers had begun to raise rates prior to September 11. Many believe, however, that both threats of unforeseen risk exposure due to the events of September 11 and subsequent diminished insurance availability have forced premium rates to increase. Additionally, insurance companies have been reevaluating their policies concerning major catastrophes.

Estimated Losses

.09 According to A. M. Best, the total insured losses from the events of that day have been estimated to be between \$35 billion and \$55 billion. A trend of reserve strengthening currently characterizes the industry. Many insurers and reinsurers have begun to enact measures to strengthen reserves by setting aside money for future claims and booking a corresponding loss on the income statement. This movement toward an increase in overall reserve strengthening could reflect a natural response by insurers to the riskier, post-September 11 environment. Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), provides guidance to auditors on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates in an audit of financial statements in accordance with generally accepted auditing standards (GAAS). Statement of Position (SOP) 92-4, *Auditing Insurance Entities' Loss Reserves*, provides guidance to help auditors understand the loss-reserving process and to develop an effective audit approach when auditing loss reserves of insurance entities.

Single Event or Multiple Events?

.10 Defining whether the September 11 attacks will be considered a single event, multiple events, or act(s) of war will broadly determine losses related to the catastrophe. A judge ruled at a hearing held on August 22 that he will bifurcate the World Trade Center (WTC) trial into two parts. The first trial will deal with which policy form governs the WTC property coverage and whether the coordinated attack on the WTC complex resulted in one insurable loss. The second trial, if necessary, would deal with WTC valuation issues.

.11 One unresolved issue is whether the federal government/taxpayers should play a permanent role as a backup insurer. By the close of 2001, Congress decided not to pass backstop legislation to provide money to the insurance industry in paying claims related to September 11 and future attacks. Because of ongoing delays surrounding this legislation, many jurisdictions have adopted optional terrorism exclusion endorsements. Many believe that these exclusions are necessary to avoid industry insolvency in the event of another catastrophe of similar or greater magnitude. Many state laws mandate that terrorism must be covered under workers' compensation policies; however, insurers are not allowed to increase rates just for terrorism coverage. One specific problem arising from the exclusions lies in defining the term *terrorism* for use in formal contracts. In addition, insurance companies are making the decision to discontinue terrorism coverage, through exclusions and other means.

.12 Congress recently formed a House-Senate conference that will address legislation regarding the creation of a federal terrorism insurance backstop. The Senate bill concentrates on providing federal revenue to the industry and policyholders; the House bill provides financing with paybacks by the entire industry. In November 2002, the House and Senate approved a terrorism insurance bill that will result in the government/taxpayers covering a set amount annually in insurance claims from any future terrorist attacks. President Bush signed this bill into law on November 26, 2002.

Insurance Fraud

.13 Insurance fraud prevention is an issue for September 11 claims because of the quantity of extensive losses, lack of crucial documentation, and difficulty in measuring business interruption losses. All these problems unearth serious potential for fraudulent behavior on behalf of claimants. In an effort to prevent insurance fraud, antifraud operations have been created and the New York Insurance Department has helped coordinate a large antifraud effort in the wake of the September 11 attacks. Unfortunately, the speed at which adjusters processed the magnitude of claims, especially considering the emotional nature of the events, also caused fraudulent claim activity to be more widespread than normal. However, the antifraud network assembled by both the New York Insurance Department and the National Insurance Crime Bureau will now crosscheck claims against other databases such as those at the Federal Emergency Management Agency, law enforcement organization, and state regulators. These preventative measures will aid in managing the fraud that arises from crises such as that of September 11.

Reinsurance Issues

.14 With the reinsurance sector responsible for an estimated \$35 billion of the September 11 losses, new capital emerged just weeks after the attacks and new reinsurers were set up in Bermuda with funding from a variety of financial sources.

.15 Considering both unpredictable earnings and the risk intensity associated with the sector, improved quality is the product now demanded by reinsurance buyers. Because financial risks of catastrophes like September 11 affect many areas of an insurance company's operations (for example, property, workers' compensation, life), buyers are now more concerned with the strength of their reinsurer. Reinsurers may need to become large, strong conglomerates to withstand future catastrophes and consumer demand; an increase in mergers and acquisitions may occur in this sector of the industry over the next few years.

.16 In addressing the risks of terrorism insurance, reinsurance pools are being considered to meet the demands of future catastrophes and to maximize capital available for paying claims. One plan for a reinsurance pool would be to pool insured losses and have a stated deductible. Pooled losses exceeding the deductible would be reinsured, and paid by reinsurers, capital markets, and possibly government/taxpayers as a last resort. Essentially, the plan aims to assign relative risk according to the financial capacity of the entity assuming it.

Property and Casualty Sector

.17 There has been ongoing improvement in the industry's financial results. However, these results are likely to be dampened by continuing claims, inflation, higher reinsurance costs, and lower interest rates generating lower investment income on insurers' portfolios. In addition, A. M. Best continues to believe that there are considerable reserve deficiencies, particularly for certain commercial coverages such as commercial automobile, workers' compensation, and medical malpractice. Large reinsurers have strengthened reserves in 2002, and there is also concern about the recoverables of some reinsurance by primary insurers. During its review of 2001, A. M. Best also raised concerns about additional asbestos and environmental claims and the potential drag on future earnings if these claims continue to be funded on a "pay as you go" basis.

.18 Claims under Directors and Officers liability insurance could become more extensive with the passage of the Sarbanes-Oxley Act of 2002, as there may be increased exposure for corporate lawsuits. Also, there is the potential for class action suits questioning the adequacy of terrorism coverage and corporate malfeasance in general.

.19 Since the September 11 attacks, there have been a number of new entrants into the reinsurance market, providing new capital in excess of \$6 billion. Reinsurers have been deemphasizing proportional coverages in favor of excess of loss coverages. This change in type of reinsurance coverage may result in primary insurers retaining greater risk, thereby subjecting surplus to greater volatility.

.20 Sales of insurance via the Internet continue to be slow. For example, Internet sales of personal automobile insurance are still less than 1 percent of total personal automobile sales. However, the Internet is becoming a more frequent means for companies' communications with their agents, policyholders, and claimants.

Auto Insurance

.21 Insurers continue to announce their intention to withdraw from New Jersey because of burdensome regulations. The largest insurer has received approval to reduce its book of business by approximately 200,000 cars. This business will need to be absorbed by other insurers. New Jersey is one of three states to have an "excess profits" regulation (New York and Florida are the others). New Jersey changed the calculation of excess profits from a paid loss to an incurred loss basis in 2002. The impact of the change is uncertain.

.22 Claims fraud has been and continues to be a problem for insurers in certain large states, most recently in New York and Florida. In particular, higher personal injury protection coverage loss ratios have resulted from fraud and abuse through unfounded lawsuits and increasing medical reviews. Auto maintenance and repair costs have been accelerating, and pricing restrictions in a number of states make sustained profitability difficult to achieve. Residual markets in New York, New Jersey, Pennsylvania, and Texas have grown in recent years.

Homeowners' Insurance

.23 The cost of insuring a home has continued to rise significantly in 2002. A. M. Best reported that the homeowner line of business was profitable for only one year during the last decade. The central region of the country has exhibited extreme volatility in homeowner results.

.24 Mold has recently become a national issue for insurers as one large insurer had a \$32 million judgment entered against it. Claims have grown exponentially. A number of carriers have stopped writing new business in Texas. Carriers have been restricting coverage for mold nationwide. Texas reacted to the "crisis" by eliminating coverage for high-priced procedures beyond those necessary for repairing water damage as part of the standard homeowner policy. However, a buy-back provision for more expensive coverage continues to exist. Mold claims have spread to other states, particularly California.

Life and Health Sector

.25 In 2002 the life and health insurance industry continued to experience challenges caused by the sluggish U.S. economy and the volatile equity markets.

.26 Annuity production, which came under pressure in 2000 and 2001, continued to experience decline in the first six months of 2002.

.27 Sales of fixed annuities started to increase in 2002, as did sales of life insurance products.

.28 In 2002, the key issues affecting life insurers include:

- Investment losses from credit deterioration
- The acceleration of amortization of deferred acquisition costs (DAC) for products accounted for in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*
- Recognition of benefits associated with variable annuity products that contain guaranteed minimum death benefits (GMDBs) and guaranteed minimum income benefits (GMIBs).
- Actions by Standard & Poor's and Moody's placing negative outlooks on the industry.

The life insurance industry has been hit hard by credit losses. Writedowns and sales of investments, both equity and fixed income, especially in the telecommunications and energy sector, have affected results. See the “Declines in the Value of Securities” section of this Alert for a description of other than temporary impairment.

.29 Declines in equity markets have resulted in exposures for accelerated amortization of DAC, particularly where the variable annuity business is concerned. Recent publicity has revealed that a number of different treatments are being used to address differences between long-term assumptions regarding market returns and actual experience. Equity market returns are particularly relevant to amortization of variable annuity DAC, since investment return (a key component of the estimation of future gross profits) is based on the valuation of the separate account assets. See the “Deferred Acquisition Costs” section of this Alert for further DAC considerations.

.30 Variable annuity products that contain GMDBs or GMIBs have two main issues to consider: (1) companies may experience general account charges for the payout of these benefits (upon either death or annuitization, as applicable) when the market value of the separate account assets are not sufficient to support the level of benefit payment and (2) generally accepted accounting principles (GAAP) and statutory accounting may require insurers to establish reserves for variable annuity guarantees on these products, thereby placing strain on capital strength. The AICPA proposed SOP *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and Separate Accounts* contains proposed guidance for accounting for GMDBs. See the “Accounting Pipeline” section of this Alert for further information on the proposed SOP.

Health Insurance Portability and Accountability Act Compliance

.31 The Health Insurance Portability and Accountability Act (HIPAA) of 1996 will be a significant initiative for health plans, health care providers, and clearinghouses that process health information electronically. Auditors should be aware that most covered entities will be required to comply with HIPAA standards by April 2003 (April 2004 for small companies that write less than \$5 million in receipts).

.32 HIPAA was adopted to improve the efficiency and effectiveness of the health care system by standardizing the electronic transmission of certain administrative and financial transactions. Significant cost reductions are projected due to the utilization of standard formats, codes, and identifiers for electronic claims. Many health care organizations may need to replace or substantially change their current systems and processes to comply with HIPAA regulations.

.33 The convergence to electronic data interchange will require significant changes to how security and privacy are addressed. As a result, HIPAA also mandates security and privacy protection standards for individually identifiable health information that is stored, processed, or transmitted. Security standards require comprehensive, formal, written procedures for protecting all patient-identifiable information stored or transmitted by any electronic system. Privacy regulations cover patient-identifiable health information in any other form that is or has been in electronic form. Patients must give their written, uncoerced, and revocable permission to use health information for purposes other than treatment, payment, healthcare operations, and specified exceptions (public health, oversight, law enforcement). Records of disclosures must be kept, and patients have the right to challenge and correct their health information.

New Products

Terrorism Coverage

.34 Insurers are revising their policies to clarify what they will and will not cover as a result of terrorist attacks. It is important for the auditor to understand precisely what risk actions a company is taking in this area as well as how the carriers’ own assets and investments may be affected.

Catastrophe Bonds

.35 The downturn in the economy and business environment has contributed to a resurgent interest in some alternative risk vehicles, such as catastrophe bonds. Catastrophe bonds are becoming more attractive to investors as an alternative to traditional risk retention. The main reasons for their increase in popularity are their transparency, simplicity, and high reward to risk ratios. Investors are willing to pay to have investments they understand and can easily follow.

.36 Catastrophe bonds are also trading well because investors are willing to try new investments to further spread their risk. These bonds are issued at a tighter spread than indemnity insurance, which makes them less risky in terms of investments. At the same time, dual-year coverage, and competition have made catastrophe bonds even more efficient. The catastrophe bond market is finally seeing participants invest for economic, and not strategic, reasons.

Containing the Cost of Weather Events

.37 Insurers, capital markets, and corporate entities are discussing methods to contain the costs of weather events. Weather risk management has become increasingly important in the last five years. And, as market sophistication continues to increase, capital and insurance markets are trading various weather risks for investors.

.38 Earthquakes, hurricanes, and tropical storms may occur infrequently but have large costs. Hail, precipitation, and temperature changes occur more frequently but tend to have lesser costs. This gives investors and insurers opportunities to mix and match the types of risk they are willing to take.

Vehicle for Facilitating Securitization

.39 The National Association of Insurance Commissioners (NAIC) has approved a Special Purpose Reinsurance Vehicle (SPRV) Model Act. The SPRV has created a vehicle for facilitating securitization within the United States, instead of at an offshore location. By allowing such vehicles within the country, states will now be able to regulate any limitations to these specific types of insurance.

The Global Insurance Industry

.40 The global insurance industry is evolving into a more complex and dynamic environment. Companies must adapt in order to gain market share and maintain profitability. Factors contributing to the evolution of the industry include:

- Increasing consolidation
- Convergence and globalization
- International mergers and acquisitions
- An evolving socioeconomic and political environment
- Changing consumer concerns and buying behavior
- Rapidly developing technology
- Broadening distribution patterns
- Increasing competition
- Rapidly changing regulations
- Increasing number of varying regulatory authorities
- Global investment strategies

- Global currency issues
- Culturally diverse workforce and customer base

.41 The new market demands that companies be specialized in a particular niche and eliminate areas in which they are not successful. One way of achieving this is through consolidation. Companies are also realizing the importance of strategic alignment with other companies to meet the needs of consumers.

.42 Additionally, the increased use of the Internet is changing the industry by eliminating global borders and reducing barriers to entry.

.43 To survive in the new global market, companies must find a way to serve their customers conveniently while also reducing costs. Many companies, as part of their cost reduction efforts, are shifting their service centers to global locations outside of the United States, or to centralized locations within the United States.

.44 Strong brands will have an advantage in this changing market. It is important to have a strong brand name to be able to access independent distribution channels. A key success strategy will be to quickly establish a brand name before existing global brands take over.

Privacy and Security—Where Are We Today?

.45 Nearly three years after passage, the privacy and security provisions contained in Title V of the Gramm-Leach-Bliley Act (GLBA) remain the cornerstone of federal efforts to regulate the handling of nonpublic personal financial information by federal and state regulated financial services institutions. Title V of the GLBA addresses the issues of how a financial services institution may use its customers' nonpublic personal information, including the providing of required notice and disclosures, and imposes upon each institution an affirmative obligation to protect its customers' information from unauthorized disclosure to internal, as well as external, sources. Under the GLBA's functional regulation approach, primary responsibility for regulation and enforcement of insurance industry compliance with GLBA's privacy and security requirements was delegated to the states.

.46 Shortly after the GLBA was signed into law, state insurance regulators, working through the NAIC, commenced the development of a privacy regulation consistent with Congress's stated goals and objectives. As permitted by language in the GLBA, permitting states may impose additional or more stringent protections, and the model developed by the NAIC includes personal health as well as financial information. The NAIC's Privacy of Consumer Financial and Health Information Model Regulation was adopted by the NAIC in September 2000.

.47 According to the NAIC, 49 states plus the District of Columbia have adopted laws or regulations, or both, that meet the GLBA's minimum privacy standards. Of these states:

- Thirty-six states plus the District of Columbia have enacted regulations or laws based on the NAIC model privacy regulation.
- Twenty-two states include the financial and health provisions of the model (two of those states have imposed "opt-in" instead of "opt-out" requirements).
- Fourteen states plus the District of Columbia contain financial but not health provisions of the model.
- Thirteen states have retained the NAIC's 1982 Model Privacy Act.

Neither the states nor the NAIC have made as much progress, however, on the development of standards for safeguarding customer information. To date only one state, New York, has adopted a security regulation. The NAIC is currently developing a model security regulation. The current proposal follows closely upon the approach taken by New York.

.48 Entities should be aware of the state privacy regulations and other emerging regulations to which the entity will be subject.

GLBA Privacy Regulations

.49 Entities were required to comply with the privacy requirements of the GLBA by July 1, 2001.

.50 The regulation on the privacy of consumers' financial information:

- Describes under what conditions an entity may disclose nonpublic personal information about consumers to nonaffiliated third parties.
- Requires an entity to provide notice to customers about its privacy policies and practices.
- Provides an "opt out" method for consumers to prevent the entity from disclosing that information to nonaffiliated third parties.

.51 ***Protected Information.*** Under the privacy regulation of the GLBA, restrictions on sharing information with nonaffiliated third parties apply to "nonpublic personal information" about a consumer. Nonpublic personal information is "personally identifiable financial information" that is provided by a consumer to an entity and results from any transaction with or service performed for the consumer, or is otherwise obtained by the entity.

.52 The regulation excludes "publicly available information" from the definition of *nonpublic personal information*. Publicly available information is any information that an entity has a reasonable basis to believe is lawfully made available to the general public from government records, widely distributed media, or disclosures to the public required to be made by federal, state, or local law.

.53 ***Privacy Policy Notice.*** Under the regulation, entities must provide a clear and conspicuous notice that accurately reflects their privacy policies and practices. The notice must be given to any individual who becomes a customer of the entity by the time the customer relationship is established, and annually as long as the relationship continues. Also, the notice must be given to any consumer who does not become a customer before nonpublic personal information about the consumer may be shared with nonaffiliated third parties.

.54 ***Opt-Out Requirement.*** Before an entity can share nonpublic personal information with nonaffiliated third parties, consumers must be given a reasonable opportunity to opt out from having that information shared. The opt-out notice must be given to:

1. Customers as a part of the initial notice of the entities' privacy policies and practices, or before sharing nonpublic personal information about them with nonaffiliated third parties.
2. Individual consumers who do not become customers of the entity, and former customers, before nonpublic personal information about them may be shared with nonaffiliated third parties.

.55 ***Exceptions.*** The regulation does provide certain exceptions that permit an entity to share nonpublic information with third parties without providing privacy or opt-out notices. These exceptions include disclosures of nonpublic personal information made in connection with certain processing and servicing transactions, with the consent of or at the direction of the consumer, to protect against potential fraud or unauthorized transactions; and to respond to judicial process.

The Sarbanes-Oxley Act of 2002

.56 On July 31, 2002, the Sarbanes-Oxley Act of 2002 (the Act) was signed into law. This Act is one of the most far-reaching pieces of legislation ever to address corporate fraud and public accounting. Support for the law was fueled by multiple reports of corporate accounting scandals, defrauded investors, and a plummeting stock market.

.57 See the AICPA general *Audit Risk Alert*—2002/03 [AAM section 8010] for further information about the Sarbanes-Oxley Act.

Congressional Hearings

.58 Hearings may be held on the adequacy of bank regulatory oversight and the possible role of investment and commercial banks in facilitating fraudulent accounting practices and other abuses. Additionally, Section 705 of the Sarbanes-Oxley Act requires the Comptroller General to conduct a study on whether investment banks and financial advisers assisted public companies in manipulating their earnings and obfuscating their true financial condition. Among other things, the study will address the role the financial institutions played in the collapse of Enron. Upon the completion of the study, the Comptroller General will issue a report discussing regulatory or legislative steps that are recommended or that may be necessary to address concerns identified in the study.

Derivatives Watch

.59 The growing number of corporate scandals has fueled increased activity in the largely unregulated derivative market. Risk managers have reshaped risk profiles in response to changing market conditions. Derivative activity at your clients and corresponding risk may increase. SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), along with its companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, provides specific guidance on auditing derivatives. Additionally, see the “FASB Statement No. 133 Implementation Guidance” section of this Alert for a discussion of the FASB Derivative Implementation Group work on insurance specific issues.

Back on the Balance Sheet Again

.60 A large portion of off-balance-sheet debt could return to the balance sheets of financial institutions and their customers as a result of changes in accounting principles and possible legislative and regulatory action. The FASB currently has a project in the works that would amend the way SPEs are reported. This project, expected to be finalized by the end of 2002, would have a major impact on financial institutions. See a description of the FASB’s work in this area in the “Special Purpose Entities” and “On the Horizon” sections of this Alert.

Audit and Accounting Issues in the Spotlight

Reinsurance Arrangements

.61 Reinsurance accounting and reporting—in particular, the question of what constitutes an acceptable transfer of risk—continues to be an important issue requiring careful analysis. The Securities and Exchange Commission (SEC) and state insurance departments have closely scrutinized the accounting and reporting practices of insurance companies with respect to reinsurance transactions.

.62 Due to a number of contributing factors, many insurance companies are reassessing the amount of exposure they retain and the types of reinsurance protection they use for risk management. As a result of the convergence of capital markets, banking and insurance purchasers of risk management products have been provided new alternatives and vehicles for redistributing risks. These new structures can take on many forms and may have unique accounting requirements based on their structure.

.63 FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, continues to be the primary source of guidance used to determine if a contract transfers risk and meets the conditions for reinsurance accounting. The following areas are factors that affect the reinsurance market and reinsurance consumers that should be evaluated.

Significant Historical Losses and a Hardening Market

.64 After steady erosion throughout most of the 1990s, reinsurance rates have been increasing across all lines of business from the beginning of this decade. The outlook for 2002 is for continued growth. The rate increases are long overdue for the industry. The rate increases reflect years of deteriorating results for the industry and reduced capacity due to insolvent reinsurers. The significant catastrophe losses from European storms and the events of September 11 have been key factors driving the most recent poor underwriting results of the reinsurance market.

.65 An increase in rates causes reinsurance consumers to question the amount of coverage they obtain and the type of reinsurance they purchase. When the cost of coverage increases, reinsurance purchasers will attempt to control their risk management costs by obtaining less coverage, purchasing higher layers, or increasing their retention.

.66 When an entity changes its risk management strategy, careful consideration should be given to whether the entity created “gaps” in coverage for which it had obtained continuous or comparable coverage. Examples of instances where this can occur include situations in which companies shift from calendar year coverages to accident year stop loss coverages, include stop loss corridors in existing coverages, or accept terms with complex excess of loss layers. In each situation, the terms and conditions of contracts need to be carefully evaluated to determine if they meet the criteria for reinsurance accounting under FASB Statement No. 113.

.67 As insurers continue to evaluate the losses reported on the significant catastrophes that have occurred, careful consideration should be given by the ceding enterprises as to the financial strength of the reinsurer. The reinsurer’s strength helps to support the collectibility of ceded loss reserves and other reinsurance balances receivable.

Regulatory Changes and Market Convergence

.68 The repeal of the Glass-Steagall Act opened the door to the convergence of capital markets and banking activities to insurance products. As a result, the reinsurance providers and consumers have many alternative risk transfer options available to them. These types of contracts often include finite risk covers that provide for a narrowly defined amount of coverage. In response to the need for innovative risk management products, underwriters and brokers are creating arrangements that are becoming more creative with unique and complex provisions.

.69 **Accounting Guidance.** Emerging Issues Task Force (EITF) Issue No. 93-6, *Accounting for Multiple Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises*, and EITF Issue No. 93-14, *Accounting for Multiple Year Retrospectively Rated Contracts by Insurance Enterprises and Other Enterprises*, represent guidance addressing issues that may be present in reinsurance transactions. These EITF issues address contractual features that create future rights and obligations as a result of past events and therefore require certain accruals to be made in the financial statements. As products become more advanced and complex, careful consideration is required to determine if the contracts are being accounted for appropriately based on a complete understanding of the facts and circumstances. Alternative risk transfer products and finite risk covers usually present complex issues with respect to evaluating the contracts for risk transfer under FASB Statement No. 113. An evaluation of such contracts should be performed with the aid of the necessary specialists, including actuaries familiar with the exposures covered under the proposed contract.

.70 SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk*, should be used to determine the appropriate method of accounting for contracts that do not meet the requirements for reinsurance accounting under FASB Statement No. 113. SOP 98-7 outlines the appropriate accounting for contracts based on one of the following categories: contracts that transfer only significant timing risk, contracts that transfer only significant underwriting risk, contracts that transfer neither significant timing nor underwriting risk, and contracts that have an indeterminate risk.

Additional Pronouncements and Proposed Projects

.71 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, states that traditional reinsurance contracts accounted for under FASB Statement No. 113 are, in most cases, not subject to the requirements of the standard. That is, a contract is not subject to the requirements of FASB Statement No. 133 if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk.

.72 One of the interpretations of FASB Statement No. 133 (Implementation Issue No. B26, *Embedded Derivatives: Dual-Trigger Property and Casualty Insurance Contracts*) identified certain types of insurance contracts that could be considered to have derivative type features. The interpretation defines policies with dual-triggers as agreements for which the payment of a claim is triggered by the occurrence of two events (that is, the occurrence of both an insurable event and changes in a separate preidentified variable). Certain types of dual trigger contracts would be subject to the provisions of FASB Statement No. 133 if more than the occurrence of an insured event was a barrier to the policyholder being availed a reimbursement under a contract. The FASB has determined all of the following conditions must be met in order for a contract possessing dual triggers to meet the scope exception and to be accounted for as a traditional insurance contract:

- Benefits and claims are paid only if an identifiable insurable event occurs.
- The amount of the payment is limited to the amount of the policyholder's incurred insured loss.
- The contract does not involve essentially assured amounts of cash flows based on the insurable event, such that recoveries under the contract are more likely determined by the referenced variable.

.73 In other words, if the occurrence of the insurable event is highly probable and the amount the insured would most likely receive is altered by the variable, the contract or a portion of it is subject to the provisions of FASB Statement No. 133.

.74 The FASB provided implementation guidance with respect to guarantee type contracts in Issue B27, *Dual-Trigger Financial Guarantee Contracts*. The interpretation states a similar conclusion to the aforementioned issue that contracts that pay for declines in value are subject to FASB Statement No. 133; however, if the payments are based on an insured loss (that is, default), the contract would meet the scope exception for traditional insurance.

Purchase Accounting

.75 Historically, many business combinations involving short-duration contracts had used the acquiree's recorded account balances as the allocated amounts for insurance-specific items in purchase accounting. In purchase business combinations involving acquisitions of property and casualty insurance companies, changes in liabilities for claim losses and loss adjustment expenses of an acquired insurance company ordinarily were made prior to the sale date through losses incurred in the seller's income statement rather than through purchase accounting adjustments. Some believe this was consistent with the SEC's Staff Accounting Bulletin (SAB) No. 61, *Adjustments of Allowances for Business Combination Loan Losses—Purchase Method Accounting*.

.76 In 1999, SAB No. 100, *Restructuring and Impairment Charges* (Topic 2-A), clarified that receivables, liabilities, and accruals should be recorded in the purchase price allocation at their fair value. Frequently, fair values are based on estimations of the underlying cash flows to be received or paid, discounted to their present value using appropriate current market interest rates. Insurers should be aware that fair value encompasses more than discounting because the cash flows related to reserves are not fixed and determinable. FASB Statement of Financial Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, provides a good framework for utilizing cash flow techniques in estimating fair value.

.77 In a speech given by the SEC staff at the December 2000 AICPA SEC conference, the staff reiterated that companies that engage in a purchase business combination should record the acquired company's liabilities using their best estimate of fair value at the date of the business combination. If a registrant believes that it has unique facts and circumstances such that it should not recognize an acquired company's liabilities or accruals at fair value, the registrant should consider preclearing its proposed accounting with the SEC staff.

.78 Auditors should be aware of this fair value consideration in recording the acquired company's liabilities and should note that the AICPA has a task force that is addressing the issue of purchase accounting for insurance enterprises. The task force will provide guidance on a purchaser's initial and subsequent accounting for purchase business combinations involving enterprises that issue short or long duration contracts, covered under insurance guidance. The task force also will address the application of FASB Statements No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets*, and the FASB Business Combinations II Project, *Applying the Purchase Method*.

Surplus Enhancement

.79 In all audits of generally accepted accounting principles (GAAP) basis and statutory accounting practices (SAP) basis financial statements, consideration should be given to the effects of unusual transactions as well as accounting differences on solvency and the adequacy of the company's SAP-basis capital and surplus. You should evaluate transactions that materially affect SAP-basis income or surplus, or transactions for which the 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 if an insurer's risk-based capital ratio is at or near a regulatory action or control level.

.80 In addition, you should be alert to significant and unusual transactions or events at or near year end that may require significant judgment about the proper accounting treatment, including the following:

- 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

.81 SOP 94-1, *Inquiries of State Insurance Regulators*, as amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*, 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.

.82 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. If you are unable to obtain such competent evidential matter for material permitted accounting practices, you should consider a qualification or disclaimer in your 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), as amended.

Money Laundering

.83 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.

Money Laundering and Financial Statements

.84 Money launderers tend to use the business entity more as a conduit than as a means of directly expropriating assets. For this reason, money laundering is far less likely to affect financial statements than other types of fraud such as misappropriations, and consequently money laundering is unlikely to be detected in a financial statement audit. In addition, other forms of fraudulent activity usually result in the loss or disappearance of assets or revenue, whereas money laundering involves the manipulation of large quantities of illicit proceeds to distance them from their source quickly and in as undetectable a manner as possible. However, money-laundering activities may have indirect effects on an entity's financial statements.

.85 Independent auditors have a responsibility under SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), to be aware of the possibility that illegal acts may have occurred, indirectly affecting amounts recorded in an entity's financial statements. In addition, if specific information comes to the auditor's attention indicating possible illegal acts that could have a material indirect effect on the entity's financial statements, the auditor must apply auditing procedures specifically designed to ascertain whether such activity has occurred.

.86 Possible indications of illegal acts include the following:

- Transactions that appear inconsistent with a customer's known legitimate business or personal activities or means; unusual deviations from normal account and transaction patterns.
- Situations in which it is difficult to confirm a person's identity.
- Unauthorized or improperly recorded transactions; inadequate audit trails.
- Unconventionally large currency transactions, particularly in exchange for negotiable instruments or for the direct purchase of funds transfer services.
- Apparent structuring of currency transactions to avoid regulatory recordkeeping and reporting thresholds (such as transactions in amounts less than \$10,000).
- Uncharacteristically premature redemption of policies, particularly with requests to remit proceeds to apparently unrelated third parties.
- The purchase of large cash value policies, soon followed by heavy borrowing against them.
- Large lump-sum payments from abroad.
- Insurance policies with values that appear to be inconsistent with the buyer's insurance needs or apparent means.
- Use of many different firms of auditors and advisers for associated entities and businesses.
- Forming companies or trusts that appear to have no reasonable business purpose.

When an auditor becomes aware of information concerning a possible illegal act, SAS No. 54 requires him or her to obtain from management—at a higher level than those employees potentially involved—information on the act's nature, the circumstances in which it occurred, and its possible effect on the client's financial statements.

.87 *Section 10A of the Securities Exchange Act of 1934.* The Private Securities Litigation Reform Act of 1995, among other things, amended the Securities Exchange Act of 1934 (the Exchange Act) to add section 10A. This section requires that each audit under the Exchange Act include procedures regarding the detection

of illegal acts, the identification of related-party transactions, and an evaluation of the issuer's ability to continue as a going concern. Section 10A also codified certain then-existing professional auditing standards regarding the detection of illegal acts by issuers and imposed expanded obligations on auditors to report in a timely manner to management any information indicating that an illegal act has or may have occurred. The auditor must ensure that the audit committee or board of directors is adequately informed of an illegal act, as broadly defined by section 10A, unless the illegal act is clearly inconsequential.

.88 In addition, section 10A requires the issuer to notify the SEC within one business day after the auditor informs the issuer's board of directors that the auditor reasonably expects either to resign from the audit engagement or to modify its audit report due to an illegal act that has a material effect on the issuer's financial statements for which appropriate remedial action has not been taken by senior management and the board of directors. If the issuer does not notify the SEC within that period, the auditor, within the next business day, must provide the SEC directly a copy of the illegal acts report (or documentation of any oral report) that it gave to the board. Section 10A provides for cease-and-desist and civil money penalties to be imposed against auditors who willfully fail to provide the required reports. Auditors should consider the advice of legal counsel when addressing possible acts subject to Section 10A.

Federal Money Laundering Regulations

.89 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. Insurance companies are defined as financial institutions under the Act (Title 31 USC 5312(a)(M)). Prior to the USA PATRIOT Act, insurance companies were not subject to BSA.

.90 On October 26, 2001, President Bush signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001. This law, enacted in response to the terrorist attacks of September 11, 2001, was intended to strengthen our nation's ability to combat terrorism and prevent and detect money-laundering activities in all financial institutions. This meant that for the first time, the insurance industry would be made subject to federal anti-money laundering rules and requirements. Broad authority to develop anti-money regulations applicable to each of the various segments of the financial services industry was delegated to the Treasury Department.

.91 On July 17, 2002, the Treasury Department, along with the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board, National Credit Union Association (NCUA), Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), Commodity Futures Trading Commission, and the SEC, issued proposed rules that would require certain financial institutions to establish minimum procedures for identifying and verifying the identity of customers seeking to open new financial accounts. These proposed rules implement Section 326 of the USA PATRIOT Act, which directs the issuance of regulations requiring financial institutions to implement reasonable procedures for (1) verifying the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintaining records of the information used to verify the person's identity; and (3) determining whether the person appears on any list of known or suspected terrorists or terrorist organizations. Final rules implementing Section 326 were effective on October 25, 2002.

.92 Unless exempted by regulation, financial institutions must establish an anti-money-laundering compliance program, including, at a minimum:

- The development of internal policies, procedures, and controls; these should be appropriate for the level of money laundering risk identified.

- The designation of a compliance officer; the officer should have appropriate training and background to execute their responsibilities. In addition, the compliance officer should have access to senior management.
- An ongoing employee training program; a training program should match training to the employees' roles in the organization and their job functions. The training program should be provided as often as necessary to address gaps created by movement of employees within the organization and turnover.
- An independent audit function should test procedures.

.93 Additionally, on January 4, 2002, interim guidance was issued to financial institutions on how to comply with two other anti-money-laundering provisions of the Act. Effective December 25, 2001, financial institutions are prohibited from providing correspondent accounts directly to foreign shell banks and are required to take steps to ensure that correspondent accounts are not being used indirectly to provide banking services to such shell banks. A "prohibited" shell bank is one that has no physical presence in a country. This excludes a shell bank that is affiliated with a U.S. or foreign bank that has a physical presence and is regulated. Additionally, financial institutions are required to keep records of the owners of foreign banks to which they provide correspondent accounts and of the foreign banks' agent designated to accept service of legal process.

Declines in the Value of Securities

.94 Major equity markets in the United States and around the world have experienced significant declines during 2002. U.S. investors are affected by market volatility related to recent, well-publicized corporate scandals and business failures, and troubled economies in various places worldwide.

.95 For accounting purposes, an impairment occurs when the fair value of an investment is lower than the cost of that investment. Impairments are either (1) temporary or (2) other than temporary. GAAP and statutory accounting principles (specifically, in accordance with the *NAIC Accounting Practices and Procedures Manual*) require that a loss be realized for other than temporary impairments of the value of investments. Significant judgment is involved in determining whether a decline in fair value is temporary or reflects conditions that are more persistent. Evidence should support management's assertion that a decline in fair value is only temporary.

Determination of Impairment

.96 **Debt and Marketable Equity Securities.** FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, discusses accounting for impairment losses recognized when fair value of a security is below cost and when that condition is "other than temporary." Management should determine whether a decline in fair value is other than temporary. If a decline is judged to be other than temporary, the cost basis of the individual security should be written down to the fair value as a new cost basis and the amount of the write-down should be included in earnings (trading securities fair value adjustments are already included in earnings). The new cost basis should not be changed for subsequent recoveries in fair value.

.97 Management's assessment of a marketable security should begin with the contemporaneous market price because that price reflects the markets' most recent evaluation of available information. Then objective evidence should be considered, such as—

- Adverse financial conditions of a specific issuer, segment, industry, region, or other variable.
- Management's ability and intent to hold the security for a period of time sufficient to recover the carrying value. Longer anticipated recovery periods give rise to uncertainty that the decline in fair value is temporary.
- Length of time that the market price has been less than cost.

- Financial condition and near-term prospects of issuer, including any specific adverse events that may influence the issuer's operations.
- Realization of a loss on subsequent disposition of the investment.
- Elimination or reduction in dividend payments, or scheduled interest and principal payments are in default.
- Rating agency downgrade of a debt security.
- Decrease in expected cash flows of a debt security.

.98 Management should display a systematic methodology that includes documentation of the factors considered. Such methodology should ensure that all available evidence concerning declines in market value below cost will be identified and evaluated in a disciplined manner by responsible personnel.

.99 *Beneficial Interests.* Certain investments, such as asset-backed or mortgage-backed obligations, represent purchased or retained beneficial interests. EITF Issue No. 99-20, *Recognition of Interest Income and Impairments on Purchased and Retained Beneficial Interest in Securitized Financial Assets*, addresses how to determine whether an impairment exists on these types of obligations. The issue's consensus requires that if the amount of (1) present value of estimated cash flows plus actual cash received since last measurement is less than (2) the present value of estimated cash flows at last measurement, for a reason other than changes in interest rates, an impairment loss must be recognized. The consensus sets out the guidance for selection of discount rate and measurement of the loss to be recognized.

.100 *Equity and Cost Method Investments In Common Stock.* Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, discusses loss recognition for other than temporary declines in the value of equity method investments (which could be applied by analogy to cost method investments). Evidence to consider would include expected future cash flows from dividends or other distributions or sale to an unrelated party, investees' inability to sustain earnings, quoted market prices (if any), or other factors evidencing the investor's inability to recover the carrying value of the investment.

.101 *Other Items.* FASB Statements No. 114, *Accounting by Creditors for Impairment of a Loan*, and No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*, address accounting for impairments of loans, such as mortgage loans. FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, addresses accounting for impairment on long-lived assets (excluding financial instruments), which would include real estate.

.102 FASB Statements No. 114 and No. 118 require that a loss be recognized if it is probable that the creditor will be unable to collect all amounts due pursuant to a loan agreement's contractual terms. FASB Statement No. 144 requires that a long-lived asset or asset group shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. An impairment loss shall be recognized if the carrying amount of a long-lived asset or asset group is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset is not recoverable if it exceeds the sum of undiscounted cash flows expected from the use and disposition of the asset.

.103 *Statutory Accounting.* Determining whether impairment has occurred on an investment under the NAIC *Accounting Practices and Procedures Manual* is similar to GAAP as described above. Management needs to consider all available evidence in determining whether an impairment exists and if that impairment is other than temporary. For each type of investment, specific measurement criteria are set out in the Statements of Statutory Accounting Principles. Differences generally do not arise between GAAP and statutory accounting principles regarding the timing of an impairment loss other than for securities subject to EITF Issue No. 99-20.

Audit Implications

.104 SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332.48), provides guidance for auditing derivative and investments in securities. SAS No. 92 indicates the following:

The auditor should evaluate (a) whether management has considered relevant information in determining whether factors exist and (b) management's conclusions about the need to recognize an impairment loss. That evaluation requires the auditor to obtain evidence about such factors that tend to corroborate or conflict with management's conclusions. When the entity has recognized an impairment loss, the auditor should gather evidence supporting the amount of the impairment adjustment recorded and determine whether the entity has appropriately followed generally accepted accounting principles.

Deferred Acquisition Costs

.105 Under GAAP, commissions, allowances, and other costs that vary with and are primarily related to the acquisition of new and renewal business are generally deferred and amortized. These deferred amounts, referred to as deferred acquisition costs (DAC), are recorded as an asset on the balance sheet and amortized to income in a systematic manner based on related contract revenues or gross profits (or gross margins as in SOP 95-1, *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, contracts), as appropriate.

DAC Recoverability and Allocation

.106 Unamortized acquisition costs are subject to recoverability and loss-recognition testing as outlined in FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*. In addition, DAC should be allocated to or directly identified with contract types or lines of businesses so these costs can be amortized over the life of the related contracts. Auditors are reminded to assess DAC recoverability and DAC allocation on their audits. Some suggestions include:

- The auditor can review the recoverability of DAC by comparing GAAP net premium with gross premiums. For unfavorable results, review loss recognition studies by line of business or contract type for possible loss recognition situations.
- The auditor can review studies comparing actual and projected experience (gross profits, mortality, morbidity, persistency, investment yields, and expenses) with those assumed for adverse deviation from the original assumptions that may indicate potential loss-recognition situations.
- For identified loss recognition situations, the auditor can determine that DAC balances are appropriately reduced or that premium deficiency liabilities are accrued.
- The auditor can evaluate reasonableness and consistency of cost allocations to lines of business or contract types and obtain explanations for unusual items.

Further DAC Considerations

.107 *Amortization.* For investment contracts, universal life-type contracts, and participating policies of mutual insurers, FASB Statement No. 97 and SOP 95-1 require that DAC be amortized over the life of a book of business at a constant rate based on the present value of estimated gross profits (EGPs) or margins. In contrast to products accounted for under FASB Statement No. 60, for which reserving and DAC assumptions are "locked in" unless premium deficiency/loss recognition is triggered, assumptions used in the FASB Statement No. 97 and SOP 95-1 calculation of DAC are "unlocked" and are subject to periodic review. Accordingly, for FASB Statement No. 97 and SOP 95-1 products, management should regularly reevaluate the underlying assumption used to determine its "best estimates" of profits and revise DAC calculations as necessary. With each reporting period, DAC amortization should be revised to reflect the most current

estimates of gross profits. In light of current competitive market conditions and changing interest rates, the auditor may want to challenge management's persistency assumptions and future gross margins incorporated in these analyses.

.108 *Investment Returns.* For variable life insurance and annuity contracts, many companies use an approach, sometimes referred to as "reversion to the mean," where the investment return assumptions in the company's EGP model reflects investment return performance over the remaining expected life of the contract such that investment return performance over the entire life of the contract achieves the company's initial expected long-term growth rate given past market performance. Other companies assume significant near-term market corrections to return to modeled account balances or use similar adjustment methodologies that in the current market environment imply significant short-term positive market performance. When using these various approaches, companies may impose various judgmental limits on the return assumptions.

.109 Regardless of the approach used to develop investment return assumptions, the prolonged decline in the equity markets and the current interest rate environment require the auditor to challenge the reasonableness of management's best estimate assumptions, accounting estimation policies for selecting their assumptions (that is, when and how to adjust their assumptions), and whether those assumptions are consistent with assumptions the company uses for other purposes (for example, the company's financial plan). Items to consider may include composition of the portfolio, the long-term and short-term asset appreciation/growth rate assumptions, and the amortization period.

.110 For universal life and deferred annuity contracts and the general account component of variable contracts, companies must make assumptions about interest rates to be earned on fixed income investment.

.111 For further information on investment management, see the "Asset-Liability Management" section in this Alert.

.112 *Persistency and Lapse Rates.* Since an increasing number of life and annuity policies contain features that were previously uncommon in traditional policy offerings, historical persistency rates may not be indicative of future persistency rates. Given competitive market conditions in which consumers are attempting to maximize yields within their risk tolerance levels, the life and annuity markets have experienced high rates of policy replacement, both external and internal, in recent years. Accordingly, practitioners may want to challenge persistency assumptions used in the calculation of DAC amortization.

.113 *Fees and Expenses.* With the emergence of accommodations to meet competition, such as increases in crediting rates, bonus interest, persistency bonuses, immediate bonus credits, and decreases in administrative charges to customers, EGPs may have declined relative to prior years. In auditing DAC, the auditor may want to review assumptions used to estimate future gross profits for consistency with management's description of its business as well as other management analyses. If inconsistencies are identified, the auditor may want to consider their implications in the determination of DAC. To the extent it is determined that assumptions used do not represent management's best estimate, the auditor should propose that management adjust those estimates and record any required adjustment.

.114 *Deferral of Costs.* For costs that are initially being deferred in the current year, the auditor should consider whether costs indeed meet the criteria for acquisition costs in FASB Statement No. 60—that is, whether they vary with and are primarily related to the acquisition of new and renewal insurance contracts. Care must be exercised to note the difference between changes in estimates and changes in accounting policies for costs that are deferred. Given the SEC's concerns regarding the nature of acquisition costs being deferred, auditors should carefully consider their procedures in these situations.

.115 *DAC Related to Internal Replacements.* GAAP concerning the treatment of existing DAC related to internal replacements is unclear. FASB Statement No. 97 requires the write-off of existing DAC when a FASB Statement No. 97 universal life contract replaces a FASB Statement No. 60 traditional life insurance

contract. However, GAAP is silent about whether to write off or maintain DAC when a policy is replaced with a comparable product (for example, when a FASB Statement No. 97 deferred annuity replaces another FASB Statement No. 97 deferred annuity). To the extent an insurer follows a policy of maintaining DAC for policies replaced by another similar contract, management should document the rationale for its position and that such rollover DAC continues to be recoverable. The AICPA currently has a task force reviewing the matter of accounting by insurance enterprises for deferred acquisition costs on internal replacements other than those specifically referenced by FASB Statement No. 97. See the “On the Horizon” section of this Alert for further information.

Deferred Taxes

.116 Auditors are reminded to assess the reasonableness of the deferred tax asset valuation allowance as it relates to such items as unrealized capital gains and losses and net operating and alternative minimum tax credit carryforwards. Deferred tax assets are reduced by a valuation allowance if, based on all available evidence (both positive and negative), it is more likely than not (a likelihood of more than 50 percent) that some portion or all of the tax benefit will not be realized. The weight given to the potential effect of negative and positive evidence should commensurate with the extent to which it can be objectively verified. Positive evidence includes tax-planning strategies (for example, strategies that would, if necessary, be implemented to accelerate taxable income to utilize expiring net operating loss carryforwards, change the character of temporary differences from ordinary to capital, or switch from tax-exempt to taxable investments). The valuation allowance recorded should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized.

Statutory Considerations

.117 It should be noted that under NAIC Codification, Statement of Statutory Accounting Practices (SSAP) No. 10, *Income Taxes*, establishes statutory accounting principles for current and deferred federal taxes, as well as foreign income taxes. The key change is that insurance companies are required to record deferred income taxes, subject to an admissibility test. While SSAP No. 10 created several implementation questions, the majority of these are addressed in Q&A 10, *A Guide to Implementation of SSAP No. 10 on Accounting for Income Taxes: Questions and Answers*. Particular attention should be paid to Q&A 10's discussion of the calculation of an insurance company's admitted deferred tax asset, the calculation and reporting of tax contingency reserves, the definition of “expected to be realized,” the use of tax-planning strategies, and the presentation and disclosure of income taxes in an insurance company's financial statements.

FASB Statement No. 133 Implementation Guidance

.118 The Derivatives Implementation Group (DIG) helps the FASB staff answer significant questions that companies face when implementing FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

.119 The FASB staff has issued guidance on numerous FASB Statement No. 133 implementation issues, and this guidance can be obtained from the FASB Web site at www.fasb.org. Following is a listing of the insurance-product-related topics that were addressed (through August 2002), together with a brief discussion of the nature of each issue and the date of FASB clearance. This list is intended to highlight to auditors of insurance companies those areas where the application of FASB Statement No. 133 may be required. In addition to the issues listed below, there are several other FASB Statement No. 133 implementation issues that are applicable to companies operating in all industries; such issues also may be relevant to an audit of an insurance company.

.120 A16—*Definition of a Derivative: Synthetic Guaranteed Investment Contracts (March 14, 2001)*. Synthetic guaranteed investment contracts meet the definition of *derivatives* in accordance with paragraph 6 of FASB Statement No. 133.

.121 B7—*Embedded Derivatives: Variable Annuity Products and Policyholder Ownership of Assets* (June 23, 1999). Traditional variable annuity products do not contain embedded derivatives that warrant separate accounting under FASB Statement No. 133 even though the insurer, rather than the policyholder, actually owns the assets.

.122 B8—*Embedded Derivatives: Identification of the Host Contract in a Non-Traditional Variable Annuity Contract* (revised September 25, 2000). Nontraditional variable annuity contracts are distinguished from traditional variable annuity contracts by the fact that investment risk associated with the assets backing the nontraditional variable annuity contracts is shared between the issuer and the policyholder. The host contract for a nontraditional variable annuity contract is the traditional variable annuity portion of the contract (that is, without the nontraditional embedded components).

.123 B9—*Embedded Derivatives: Clearly and Closely Related Criteria for Market Adjusted Value Prepayment Options* (December 6, 2000). The economic characteristics and risks of the embedded derivative (market-adjusted value prepayment option) in a market value annuity contract are clearly and closely related to the economic characteristics and risks of the host contract and therefore need not be bifurcated in accordance with paragraph 12 of FASB Statement No. 133.

.124 B10—*Embedded Derivatives: Equity Indexed Life Insurance Contracts* (July 28, 1999). The existence of a death benefit provision does not exclude the entire equity-indexed life insurance contract from being subject to FASB Statement No. 133 for either the issuer or the policyholder because the policyholder can obtain an equity-linked return by exercising the surrender option before death.

.125 B25—*Embedded Derivatives: Deferred Variable Annuity Contracts with Payment Alternatives at the End of the Accumulation Period*. Deferred variable annuity contracts may contain minimum benefit guarantees in either the accumulation or payout phases of the contract. This issue provides derivative accounting guidance for four separate minimum guarantee scenarios.

.126 Implementation guidance on this issue was originally posted to the FASB Web site on April 10, 2001. The effective date of the December 19, 2001, revisions to the implementation guidance is the first day of the first fiscal quarter beginning after January 9, 2002, the date that the revised FASB-cleared guidance was posted on the FASB Web site. Those revisions related to a period-certain-plus-life-contingent variable-payout annuity contract.

.127 B26—*Embedded Derivatives: Dual-Trigger Property and Casualty Insurance Contracts* (March 14, 2001). A property and casualty contract that provides for the payment of benefits and claims as a result of both an identifiable insurable event and changes in a variable would not contain an embedded derivative instrument that is required to be separately accounted for under FASB Statement No. 133 provided (1) benefits and claims are paid only if an identifiable insurable event occurs (for example, theft or fire), (2) the amount of the payment is limited to the amount of the policyholder's incurred insured loss, and (3) the loss is not virtually certain to occur.

.128 B27—*Embedded Derivatives: Dual-Trigger Financial Guarantee Contracts* (March 14, 2001). A financial guarantee insurance contract for which payment of a claim is triggered only by the occurrence of the insured's credit losses exceeding a specified level on its loans held (though the amount of the payment is affected by the credit losses in a customized pool of loans by third parties exceeding the same specified level) is an insurance contract that is not subject to FASB Statement No. 133 requirements because it indemnifies the insured for its actual losses incurred above a specified level. A provision limiting claims in the event the insured's credit losses exceed the credit losses in a referenced pool or index of consumer loans represents a type of deductible, rather than an embedded derivative that warrants separate accounting under FASB Statement No. 133.

.129 B28—*Embedded Derivatives: Foreign Currency Elements of Insurance Contracts* (March 14, 2001). Contracts that pay claims in a currency different from the one in which the loss is measured at a predetermined contract exchange rate are not deemed to have an embedded foreign currency derivative.

.130 B29—*Embedded Derivatives: Equity-Indexed Annuity Contracts with Embedded Derivatives* (March 14, 2001). Equity-indexed annuities that contain “point-to-point” or “ratchet design” features qualify as contracts with embedded equity derivatives that must be bifurcated and reported at fair value in accordance with paragraph 12 of FASB Statement No. 133.

.131 B30—*Embedded Derivatives: Application of Statement 97 and Statement 133 to Equity-Indexed Annuity Contracts*. Equity-indexed annuities contain a debt instrument with an embedded (equity option) derivative. Upon receipt of the consideration for the equity-indexed contract, the issuer is required to allocate a portion of the consideration to the derivative and the remainder to a fixed annuity host contract. Interest credited and changes in the fair value of the derivative should be recognized in earnings. The host contract should be accreted to the minimum account value at the end of the contract using the effective yield method. A minimum liability shall not be recorded if, prior to the maturity of the contract, the aggregate of the host account value and the market value of the derivative is less than the value of the contract on a FASB Statement No. 97 basis (that is, without bifurcating the derivative).

.132 B31—*Embedded Derivatives: Accounting for Purchases of Life Insurance* (July 12, 2001). FASB Technical Bulletin No. 85-4 prescribes the accounting for life insurance contracts commonly referred to as COLI (corporate-owned life insurance), BOLI (business-owned life insurance), and key-man insurance. This accounting treatment is applicable even though these insurance contracts include derivative-like provisions that would otherwise require separate accounting as derivatives under paragraph 12 of FASB Statement No. 133.

.133 C1—*Scope Exceptions: Exception Related to Physical Variables* (February 17, 1999). If a contract contains a payment provision that requires the issuer to pay to the holder a specified dollar amount based on a financial variable, the contract is subject to the requirements of FASB Statement No. 133 because it would not meet the exclusion in paragraph 10(e)(1) of FASB Statement No. 133.

.134 C7—*Scope Exceptions: Certain Financial Guarantee Contracts*. For financial guarantee contracts, the scope exception in paragraph 10(d) of FASB Statement No. 133 does not apply if such contracts do not require exposure to and incurrence of a loss as a precondition for payment. Furthermore, to qualify for the scope exception in paragraph 10(d), the compensation paid under such contracts cannot exceed the amount of the losses incurred by the guaranteed party.

.135 The FASB initially cleared this issue on July 28, 1999; however, at the March 13, 2002 meeting, the FASB decided to amend paragraph 10(d) of FASB Statement No. 133. That amendment will be included in an exposure draft (ED) containing various amendments of FASB Statement No. 133. Accordingly, the guidance in this issue may be revised or rescinded if a proposed amendment to FASB Statement No. 133 is finalized.

.136 G4—*Cash Flow Hedges: Hedging Voluntary Increases and Interest Credited on an Insurance Contract Liability* (July 28, 1999). FASB Statement No. 133 would permit an insurance company to qualify for cash flow hedge accounting if it is hedging the possibility that it may need to voluntarily increase the interest rate used to credit interest on certain whole life, universal life, repetitive premium variable annuity, and single premium variable annuity contract liabilities. However, to qualify for cash flow hedge accounting, changes in the hedged interest payments attributable to the hedged risk must be sufficiently correlated with the changes in the cash flows of the hedging derivative.

Special Purpose Entities

.137 On July 1, the FASB issued an ED of a proposed interpretation entitled *Consolidation of Certain Special-Purpose Entities, an Interpretation of ARB 51*. If issued in a final interpretation, the provisions of the ED would establish new guidance on the accounting and reporting for the consolidation of special-purpose entities (SPEs). The provisions of the proposed guidance are required to be applied by all entities (excluding

not-for-profit organizations) that are involved with an SPE. Insurance companies may participate in SPEs through investing in structured investments, such as asset-backed securities, synthetic asset-backed securities and catastrophe bonds, certain structured reinsurance deals, joint ventures without substantive operations, financial guarantees, debt issuance vehicles, or limited partnerships.

.138 See the AICPA general *Audit Risk Alert*—2002/03 [AAM section 8010] for a detailed discussion of SPEs.

Two-Step Securitization Required

.139 Nonbank securitizers tend to use a two-step process to structure many securitizations to satisfy the isolation requirements of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. FASB Statement No. 140 requires that transferred assets must be put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. If transferred assets are not sufficiently isolated, the transfers will not qualify for sale treatment under GAAP, and the transferred assets must be reported as assets on the entity's balance sheet. The two-step approach solves the problem of complying with this isolation requirement.

.140 However, some entities may use a single-step approach when securitizing. This single-step approach makes the securitization vulnerable to an arcane legality called an "equitable right of redemption." This legality might theoretically permit a transferor to recover transferred assets, which is at odds with FASB Statement No. 140's isolation requirement. Recent FASB guidance requires transferors to utilize the two-step approach to structure many securitizations (assuming that the goal is to account for the securitization as an off-balance-sheet sale). The change will affect many deals, particularly revolvers and deals that feature securities issued in debt form.

Steps for Securitization

.141 What are the steps for the proper isolation of a securitization?

1. The parent (*P*) establishes a wholly owned subsidiary (*S*), carefully designed to be bankruptcy remote. *P* transfers assets to *S*, and a payable arises for *S*. Even without the exchange of cash, lawyers deem this transfer a true sale. As a result, accountants are content that the transaction satisfies the isolation requirement of FASB Statement No. 140. However, at this point, no funds have been raised and securitization has not yet occurred.
2. In step 2, *S* transfers assets to the Issuer (*I*) for the exchange of cash and a retained interest in *I*'s assets. *I* is a securitization vehicle (often but not necessarily a qualifying special purpose entity (QSPE)). Step 2 introduces credit enhancements so the retained interest may be subordinated to *I*'s senior interests or *S* may be entitled to reserve fund proceeds if credit losses aren't above expectations. Enhancements such as these leave doubt that step 2 is a true sale alone. Instead step 2 might be judged only a secured borrowing, falling short of FASB Statement No. 140 criteria.
3. Subsequent to step 2, *I* may issue assets to third-party beneficial interests in exchange for cash and use the funds received to purchase assets (for example, pools of credit card balances from the bank).

.142 FASB Statement No. 140 permits an aggregate holistic view of the first two steps for an isolated securitization transaction and rules that isolation has been met because of the first step. However, many entities have set up transactions without step 1; with *P* transferring assets directly to *I*, with *I* being only a QSPE that is not bankruptcy remote, rather than an isolated subsidiary.

Transition

.143 To restructure current deals, entities usually must obtain the affirmative approval of a majority of investors in each of the beneficial interests (step 3). Therefore, transition time will end on the earlier of obtaining the necessary investor approvals or five years subsequent to the publication of FASB Technical

Bulletin No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*. This bulletin was issued to provide transitional relief to entities that are faced with some difficult logistical consequences of the new two-step securitization requirement.

.144 Use the following table to see when an entity must apply the proposed transition provision.

<i>The parent (P) transfers assets directly to an Issuer (I) in a single-step securitization and:</i>	<i>FASB Statement No. 140 Transition Rules</i>	<i>Transition Guidance of Technical Bulletin</i>
No assets are transferred and no beneficial interests are issued after March 31, 2001.	FASB Statement No. 140 does not apply. Continue to account for the old transfers under accounting standards prevailing at the time of the transfer.	None needed.
Assets are transferred after March 31, 2001, pursuant to pre-March 31, 2001, commitments to third-party beneficial interest holders (e.g., a revolving commitment in a credit card deal). No new beneficial interests issued after March 31, 2001.	FASB Statement No. 140 does not apply. Account for the committed transfers under accounting standards prevailing at the time of the commitment.	None needed.
Assets are voluntarily transferred after March 31, 2001 (e.g., not pursuant to a commitment) and new beneficial interests are issued.	Transfer requirements of FASB Statement No. 140 apply for post March 31, 2001, transfers. If the Issuer is a QSPE, FASB Statement No. 140 QSPE guidance applies.	Yes. The isolation provisions of FASB Statement No. 140 continue to apply to transfers. Additional transition time may be available.

.145 FASB notes that many series of beneficial interests outstanding today will have paid off within the five-year window, eliminating the need for the entity to obtain approval from these series holders. However, the one condition that must be met before an entity can benefit from additional transition rules is that all new beneficial interests issued after the publication of the technical bulletin must permit the use of a two-step transfer.

Auditing Considerations

.146 The structure of transactions must be examined for legal isolation requirements and the timing of transactions will need to be scrutinized for proper compliance.

.147 The value of retained interests in securitizations must be supported by objectively verifiable documentation of the assets' fair market value, using reasonable, conservative valuation assumptions. Auditors should determine that an entity complies with the accounting requirements encompassed in FASB Statement No. 140, and FASB Technical Bulletin No. 01-1, *Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets*.

.148 Additionally, the Audit Issues Task Force issued Auditing 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. 140," of SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 9336.01-.21). The guidance reflects changes in accounting guidance that has occurred since the 1998 interpretation. For a copy of the interpretation, visit the AICPA Web site at www.aicpa.org/members/div/auditstd/announce/index.htm.

SEC Disclosure Information

.149 The AICPA Insurance Liaison Task Force understands from comment letters and discussions with the SEC staff that the following disclosure areas should be improved for filings starting in 2002.

Loss Reserves

.150 The SEC staff desires improved explanations for changes in reserve estimates. More specifically, the staff wants disclosure about changes in estimates by line of business, better explanations of the facts involved in the estimates or new information since the last report date underlying the improved insight on estimates, and a more robust discussion of the company's remaining exposure to uncertainty. With respect to the last point, the SEC staff is concerned that investors place a higher degree of precision on loss reserve estimates than exists. Therefore, investors should be provided information relating to uncertainties inherent in the estimates. This disclosure should not be a boilerplate discussion of reserves, rather, it should address the specifics of what "keeps management up at night."

Other Than Temporary Impairments of Securities

.151 The SEC staff mentioned that discussion should include the company policy for evaluating other than temporary impairments, the amount of impairment, how the impairment was measured, as well as the factors that gave rise to the impairment and whether those factors would affect other investments. The SEC staff expects this level of disclosure each quarter for all material impairments given current market conditions.

Realized Losses on Investments

.152 Discussion should include the amount of loss and the fair value at the date of sale as well as the reasons for sales if the company previously asserted the ability and intent to hold the investment to maturity, in order to justify the lack of an impairment loss. The SEC staff expects this level of disclosure each quarter for all material losses given current market conditions.

Unrealized Losses on Investments

.153 Discussion should include concentrations of securities with a loss. Additionally, the company should disclose the length of time that securities have been under water, in table format, by class of security, and broken out between investment and noninvestment grade investments. The SEC staff expects this level of disclosure each quarter for all material losses given current market conditions.

Accounting Policy Disclosures

.154 The SEC staff noted that, in general, registrants should provide more specific information regarding critical accounting policies, especially if the policies are in areas where there is known diversity in practice, such as for guaranteed minimum death benefits.

Asset-Liability Management

.155 Most insurance companies have separate investment departments responsible for managing a company's funds that are available for investments. Some insurance companies outsource the practice to vendors. In either case, investments need to be planned so their maturities match their claims payment patterns. This is generally referred to as *asset-liability management* or *asset/liability matching*—that is, funds are invested so the income from these investments plus maturities will meet the ongoing cash flow needs of the company. This matching approach requires a correct mix of long- and short-term investments.

.156 The rate environment has unexpectedly changed drastically over the past few years. In 2001, the FRB cut rates nine times, for a total of 450 basis points. The short-term rate was 2.0 percent in October 2001,

held at 1.75 percent throughout the first three quarters of 2002 and finally was reduced to 1.25 percent in November 2002, the lowest rate in 41 years. However, prior to 2001, the opposite was occurring and the FRB had raised rates six times over a period of 12 months. The September 11 events increased cash outflow via claims payments for many insurance companies, while at the same time the corresponding low interest rate environment decreased the asset values and/or income of insurance company investments, complicating the prior year's projected asset/liability balance. This is especially true of mortgage assets—see the next section in this Alert titled “Mortgage News” for more information. Insurance industry portfolio management is no longer business as usual. The asset-liability mix is constantly changing and investment options are expanding and becoming more complex. One must monitor portfolio risk and performance in relation to accounting, tax, and regulatory concerns.

.157 Dramatic interest rate swings may continue to occur and have tremendous impact on an entity's revenue streams, asset values, liquidity, margins, share, and loan demand. It is essential that management plan for these changes. Solid asset-liability management procedures, financial planning, and investment strategy come into play. With proper planning and solid policies and procedures in place, institutions can manage these changes and properly assess the impact of alternative actions. Without proper planning, there exists serious risk of financial problems, including unnecessary losses and declines in asset values.

.158 Whether the insurance company has an in-house asset-liability management (ALM) program or has outsourced ALM to an outside vendor, it is important that management understand the ALM program and its results. If the institution has an in-house program, management needs assurance that the program is run correctly. If an outside ALM vendor is used, management needs to understand the vendor's modeling results and the assumptions used. The degree of sophistication needed varies with the complexity of the balance sheet.

.159 ALM programs can be complex and require sophisticated assumptions to be properly run. Personnel running ALM programs may not fully understand the intricacies of the model or may not have developed reasonable assumptions to produce reasonable results. Therefore, financial planning may be based on faulty premises and data. A couple of typical examples of ALM modeling errors include the following:

- *Inaccurate or unreliable prepayment assumptions.* Has the institution established prepayment assumptions in the model? Are the assumptions reasonable and periodically updated? Do prepayment speeds change with interest rates? Does management know what the prepayment assumptions are? If the answer to any of these questions is no, the ALM model's output may be suspect.
- *No core deposit or decay rates.* Decay rates are the assumed maturity of nonmaturity deposits. If decay rates are not reasonable, the model results will not be reliable.
- *Inaccurate input of data.* Detail reports should be run to review the data for errors in the way the model is run and to determine whether the data has been inaccurately input into the model. One basic test is to compare the model results with actual history.

.160 Management needs to ensure that any ALM modeling is performed reasonably and accurately to analyze important variables. These include portfolio market value, interest rate sensitivity, and earning potential, as well as the simulation of income, balance sheet, duration, risk-based capital requirements, and cash flow implications over a variety of scenarios and time horizons. Asset allocation studies to determine optimal performance within prescribed risk tolerance and statutory limitations are also paramount. In the current low-interest rate environment, insurance companies need to be diligent in their financial management process and thoroughly aware of financial and interest rate risks. Each company needs to carefully evaluate its investment and financial decisions.

Mortgage News

.161 While no one could picture any year surpassing the mortgage boom of 2001, analysts are now predicting that 2002 will exceed the prior year's millennium mortgage madness. Mortgage interest rates have

spiraled down to those existing during the Eisenhower years. This is not surprising, as history shows that strong housing markets follow strong stock markets by approximately two years.

.162 It is possible that interest rates will hit bottom by the end of 2002. A large portion of an insurance company's investment portfolio may consist of commercial, real estate, and residential loans. Unfortunately, many institutions now hold many long-term, fixed-rate mortgages in an effort to keep net interest margins from falling further than they have this year. Therefore, the refinance boom has left many institutions with high concentrations of fixed-rate, 15- and 30-year mortgages because debtors like to lock in long-term low rates during a decline. Markets for variable rates have suffered.

Some Audit Considerations

.163 You may need to consider whether your client has adequate ALM procedures in place to understand and manage its market and liquidity risk in a falling interest rate environment. Institutions now have asset heavy portfolios on their books that have been hard to sell during the low rate economy. These assets are risky for two reasons. First, since some institutions lend long term and borrow short term, the asset/liability balance may be detrimental when the cost of borrowing increases during a rise in rates. (Many long-term assets are now locked in at rates unheard of two years ago.) Second, overvalued home appraisals during the current housing market boom may lead to the receivables and foreclosed assets themselves being overvalued.

.164 Additionally, voluminous low-interest-rate refinancing will affect your client's operations and earnings. Profits may suffer substantial decline and could lead to going-concern implications. Also, management may experience intense pressure from stakeholders to maintain profitability, thereby increasing the institution's risk of fraud.

.165 Although the loan origination and servicing fee revenues earned may increase due to an influx of new customers, margins may decrease as interest rates decline. Institutions are subject to prepayment risk in falling rate environments. Mortgage loans may be prepaid by a debtor to refinance the obligation at a new, lower rate. If an institution does not have an effective system for generating new mortgage loans in a period of significant prepayments, the institution's future investments may be negatively affected. Prepayments of assets carrying the old, higher rates reduce the institution's net income and overall asset yields. In addition to loans, other items such as securities, deposits, debts, and derivatives all depend on interest rates.

.166 Finally, many loans have been refinanced. Second-mortgage lenders rank below first-lien holders in collection efforts, and the holder of the second lien is not able to collect until the first lender has been paid. Therefore, one should note the creditor status of the client's portfolio base.

Mortgage Loan Servicing and Secondary Market Sales

.167 Some institutions have been significantly increasing their real estate loan portfolios, as well as enhancing their servicing portfolios of loans sold in the secondary market with servicing retained by the institution. Institutions in recent years have been much more likely than in the past to retain servicing for loans sold to secondary market investors. Not only has the number of institutions that are servicing portfolios grown considerably, but the size and dollar amount of institutions' servicing has also increased. Conversely, the recent refinancing boom has adversely affected certain institutions, as borrowers have moved to other institutions in the highly competitive market.

.168 The value of associated mortgage-servicing rights (MSRs) is an important area for an auditor and may have a significant effect on a client's financial statements this year or in the near future.

Audit and Accounting Guidance

.169 Several publications provide guidance related to mortgage loan servicing:

- FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- The AICPA Audit and Accounting Guides *Banks and Savings Institutions and Audits of Credit Unions*
- SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*

.170 The FASB published a special report on February 15, 2001, that addresses the most frequently asked questions about FASB Statement No. 140. On April 19, 2001, the FASB staff published a set of questions and answers about isolation of financial assets transferred by entities, focusing on rights of redemption. Finally, on August 7, 2001, the FASB staff published a set of questions and answers about the limitations on the activities of a qualifying special-purpose entity set forth in paragraphs 35 through 44 of FASB Statement No. 140.

.171 For any insurance company that may have mortgage servicing operations, the auditor should evaluate whether the institution is complying with the relevant accounting requirements. The auditor should gain assurance that the financial institution is properly recording the asset (or liability), and gain or loss on sale when loans are sold with servicing retained. Assurances should also be made that the institution is properly amortizing the MSRs and that procedures are in place to properly assess fair value for potential impairment.

.172 Additionally, the various mortgage-related entities, such as the Department of Housing and Urban Development (HUD), Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC, also known as Freddie Mac), and Government National Mortgage Association (GNMA, also known as Ginnie Mae) have various audit and reporting requirements.

.173 Another consideration is further activity related to the sales of such loans. As the income is recorded up-front at the sale date and the MSRs are amortized to expense in proportion to net servicing income, if the current level of sales activity is not sustained, the institution will be affected by the loss of such sales income.

.174 Apart from the proper accounting treatment for loans sold and for retained servicing, the auditor may also want to evaluate the internal control of the servicing operations. Your client will have numerous financial and compliance obligations and responsibilities, such as collecting and remitting loan payments, ensuring compliance with federal and state regulations covering escrow accounts, and other servicing requirements; compliance with the seller servicing agreement with a third party, such as Fannie Mae and Freddie Mac; properly collecting on delinquent accounts; and collecting and paying taxes and insurance. Failure to properly comply with any of these requirements could have serious financial impact on the institution.

Recent Regulatory Developments

Codification of Statutory Accounting Principles

.175 In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises. In 2002, the NAIC published the *Accounting Practices and Procedures Manual*, as of March 2002 (the revised Manual), which included modifications of and additions to the previously issued Manual (as of March 2001). The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the revised Manual except as prescribed or permitted by state law. Most of the requirements of the revised Manual were effective for implementation on January 1, 2001. However, new statutory accounting guidance continues to be developed through a maintenance process that creates and clarifies statutory accounting principles promulgated by the NAIC. Four new SSAPs were effective for implementation on January 1, 2002:

1. SSAP No. 76, *Reporting on the Costs of Start-Up Activities*
2. SSAP No. 77, *Real Estate Sales—an Amendment to SSAP No. 40, Real Estate Investments*
3. SSAP No. 81, *Software Revenue Recognition*
4. SSAP No. 82, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Web Site Development Costs*

In addition, 30 new interpretations were adopted during 2001 and incorporated in the revised Manual.

.176 The Preamble of the revised Manual notes the following as the statutory hierarchy, which is not intended to preempt state legislative and regulatory authority:

- Level 1:
 - SSAPs, including GAAP reference material categories a, b, and c from the GAAP hierarchy
 - Category a includes FASB Statements and Interpretations, APB Opinions, AICPA Opinions, and AICPA Accounting Research Bulletins
 - Category b includes FASB Technical Bulletins, AICPA industry Audit and Accounting Guides, and AICPA Statements of Position
 - Category c includes consensus positions of the FASB EITF and AICPA Practice Bulletins
- Level 2:
 - Consensus positions of the Emerging Accounting Issues Working Group as adopted by the NAIC
- Level 3:
 - NAIC Annual Statement Instructions
 - NAIC Purposes and Procedures of the Securities Valuation Office Manual
- Level 4:
 - Statutory Accounting Principles Statement of Concepts
- Level 5:
 - GAAP reference material below Category c in the GAAP Hierarchy

.177 Prescribed statutory accounting practices are practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. States have adopted the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence.

.178 Permitted statutory accounting practices include practices not prescribed by the domiciliary state but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (1) if it wishes to depart from the prescribed statutory accounting practice or (2) if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future.

Guidance for Auditors

.179 Insurance enterprises prepare SAP-basis financial statements in accordance with the accounting practices and principles prescribed or permitted by the insurance departments of their states 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).

.180 You should understand the accounting and reporting requirements of the revised Manual, as adopted by the domiciliary state insurance regulatory authority, and monitor the status of new authoritative guidance maintained and promulgated by the NAIC to evaluate its impact on insurance clients. Proposed guidance related to new statutory accounting principles can be accessed on the NAIC Web site at www.naic.org/1finance/sapwg/index.htm. Proposed guidance responding to questions of application, interpretation, or clarification of existing statutory accounting principles can be accessed on the NAIC Web site at www.naic.org/1finance/eaiwg/index.htm. In addition, the NAIC has created a password-protected Web site to enable holders of the revised Manual to download authoritative guidance adopted by the NAIC subsequent to the issuance of the revised Manual to keep abreast of changes to statutory accounting. This Web site may be accessed by the public at www.naic.org/1finance/SAPmenu.htm. The user identification and password to access this site is located on the front cover of the revised Manual.

.181 Appendix A-205 of the revised Manual, *Illustrative Disclosures of Differences between NAIC Statutory Accounting Practices and Procedures and Accounting Practices Prescribed or Permitted by the State of Domicile*, highlights disclosure requirements in statutory financial statements to reconcile net income and statutory surplus when state-prescribed or permitted statutory accounting practices differ from NAIC statutory accounting practices contained in the revised Manual. This reconciliation is required in both quarterly statements and the annual statements submitted to the NAIC, excluding single-state insurance writers.

Statement of Position 01-5

.182 In December 2001, the AICPA's Accounting Standards Executive Committee (AcSEC) issued SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*, to modify AICPA guidance affected by Codification.

.183 SOP 01-5 amends SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, and requires insurance enterprises to disclose, at the date each balance sheet is presented, beginning with financial statements for fiscal years ending on or after December 15, 2001, a description of the prescribed or permitted statutory accounting practice and the related monetary effect on statutory surplus of using an accounting practice that differs from either state-prescribed statutory accounting practices or NAIC statutory accounting practices.

.184 Those disclosures should be made if (1) state-prescribed statutory accounting practices differ from NAIC statutory accounting practices or (2) permitted state statutory accounting practices differ from either state prescribed statutory accounting practices or NAIC statutory accounting practices, and the use of prescribed or permitted statutory accounting practices (individually or in the aggregate) results in reported statutory surplus or risk-based capital that is significantly different from the statutory surplus or risk-based capital that would have been reported had NAIC statutory accounting practices been followed.

.185 SOP 01-5 includes the following auditing guidance that has been updated as a result of the completion of the NAIC Codification:

- SOP 95-5, *Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises*
- SOP 94-1, *Inquiries of State Insurance Regulators*
- Auditing Interpretation No. 12, "Evaluation of the Appropriateness of Informative Disclosures in Insurance Enterprises' Financial Statements Prepared on a Statutory Basis," of SAS 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623.60–.77).

The auditing guidance included in the above has been approved by the Auditing Standards Board (ASB).

.186 SOP 01-5 is effective for annual financial statements for fiscal years ending on or after December 15, 2001, complete sets of interim financial statements for periods beginning on or after that date, and audits of those financial statements.

Regulatory Observations: Access to CPA Audit Documentation

.187 The NAIC Financial Reporting Working Group has discussed with the AICPA-NAIC Task Force concerns related to an insurance regulator's access to an external auditor's audit documentation. An external auditor is required by the NAIC Model Audit Rule to provide timely access to or copies of audit documentation when requested by regulators.

.188 Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," of SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 9339.01-.15), states, in part:

.02 *Interpretation*—When a regulator requests access to audit documentation pursuant to law, regulation or audit contract, the auditor should take the following steps:

- a. Consider advising the client that the regulator has requested access to (and possibly photocopies of) the audit documentation and that the auditor intends to comply with such request. (In some cases, the auditor may be required by law or regulation to confirm in writing that the auditor may be required to provide a regulator access to the audit documentation.)
- b. Make appropriate arrangements with the regulator for the review.
- c. Maintain control over the audit documentation, and
- d. Consider submitting the letter described in this Interpretation to the regulator.

.03 The auditor should make appropriate arrangements with the regulator. These arrangements ordinarily would include the specific details such as the date, time and location of the review. The audit documentation may be made available to a regulator at the offices of the client, the auditor, or a mutually agreed-upon location, so long as the auditor maintains control. Furthermore, the auditor should take appropriate steps to maintain control of the audit documentation. For example, the auditor (or his or her representative) should consider being present when the audit documentation is reviewed by the regulator. Maintaining control of audit documentation is necessary to ensure the continued integrity of the audit documentation and to ensure the confidentiality of client information.

Submitting the audit documentation transmittal letter referred to in Interpretation No. 1 to the regulator would provide clarity on the purpose and use of audit documentation. Interpretation No. 1 also addresses the necessity to maintain control and ownership of the audit documentation.

.189 Practitioners should be aware that the AICPA's task force on NAIC matters is actively working with an NAIC designated group of examiners to pursue ways to increase the examiners' reliance upon the statutory audit and use of underlying audit documentation. One aspect of this project involves development of protocols regarding regulatory access to the CPA's audit documentation prior to the completion of the statutory audit. In this regard, the task force understands from representatives of the NAIC that each state, as a requirement of the accreditation standard, is required to provide confidential treatment of the CPA's audit documentation prepared in connection with a statutory audit. The AICPA also is aware that a number of firms are planning to designate a contact person for regulator reference in pursuing resolution of questions with respect to these firm's individual engagements to perform statutory audits. Firms or individual practitioners performing statutory audits of regulated insurance entities who wish to designate a liaison should contact NAIC representative Annette Knief at (816) 783-8006 or Julie Glaszcz at (816) 783-8132.

Indemnification Clauses by CPAs

.190 In March 2002, the NAIC concluded its discussions on proposed revisions to the Model Audit Rule and voted to prohibit the use of release and indemnification clauses by CPAs who perform audits on statutory financial statements, beginning with 2002 audits. The revised language is as follows:

Section 7. Qualifications of Independent Certified Public Accountant

- A. The commissioner shall not recognize a person or firm as a qualified independent certified public accountant if the person or firm . . .
- (2) Has either directly or indirectly entered into an agreement of indemnity or release from liability (collectively referred to as *indemnification*) with respect to the audit of the insurer.

New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance

.191 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 95	<i>Generally Accepted Auditing Standards</i>
SAS No. 96	<i>Audit Documentation</i>
SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i>
SAS No. 100	<i>Interim Financial Information</i>
SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>
SSAE No. 11	<i>Attest Documentation</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i>
SQCS No. 6	<i>Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>
Audit Guide	<i>Service Organizations: Applying SAS No. 70, as Amended</i>
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i>
Auditing Interpretation No. 1 of SAS No. 73	<i>"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. 140"</i>
Audit Interpretation No. 4 of SAS No. 70	<i>"Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls"</i>
Audit Interpretation No. 5 of SAS No. 70	<i>"Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods"</i>

(continued)

Audit Interpretation No. 12 of SAS No. 1, section 420	"The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Changes in the Year of Adoption"
Audit Interpretation No. 14 of SAS No. 58	"Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing"
Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Practice Alert 02-1	<i>Communications With the Securities and Exchange Commission</i>
Practice Alert 02-2	<i>Use of Specialists</i>
Practice Alert 02-3	<i>Reauditing Financial Statements</i>
Practice Aid	<i>Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide</i>
Practice Aid	<i>New Standards, New Services: Implementing the Attestation Standards</i>
Practice Aid	<i>Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users</i>

.192 Of the pronouncements and other guidance listed in the previous table, those having particular significance to the insurance industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*

.193 SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316A); amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230); and amends SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), as amended. The Statement does not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1 (AU sec. 110.02).¹ However, SAS No. 99 establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.²

¹ The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). 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 (see SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 312]), or fraud.

² Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statement in accordance with generally accepted auditing standards. Chapter 1, "Attest Engagements," of Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101), and Statement on Standards for Consulting Services (AICPA, *Professional Standards*, vol. 2, CS sec. 100) provide guidance to accountants relating to the performance of such services.

.194 The following is an overview of the content of the SAS No. 99, with references to paragraphs in the new fraud standard:

- *Description and characteristics of fraud.* This section describes fraud and its characteristics. (See paragraphs 5 through 12.)
- *The importance of exercising professional skepticism.* This section discusses the need for auditors to exercise professional skepticism when considering the possibility that a material misstatement due to fraud could be present. (See paragraph 13.)
- *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.* This section requires, as part of planning the audit, that there be a discussion among the audit team members to consider how and where the entity's financial statements might be susceptible to material misstatement due to fraud and to reinforce the importance of adopting an appropriate mindset of professional skepticism. (See paragraphs 14 through 18.)
- *Obtaining the information needed to identify risks of material misstatement due to fraud.* This section requires the auditor to gather information necessary to identify risks of material misstatement due to fraud, by:
 1. Inquiring of management and others within the entity about the risks of fraud. (See paragraphs 20 through 27.)
 2. Considering the results of the analytical procedures performed in planning the audit. (See paragraphs 28 through 30.)
 3. Considering fraud risk factors. (See paragraphs 31 through 33, and the appendix, "Examples of Fraud Risk Factors.")
 4. Considering certain other information. (See paragraph 34.)
- *Identifying risks that may result in a material misstatement due to fraud.* This section requires the auditor to use the information gathered to identify risks that may result in a material misstatement due to fraud. (See paragraphs 35 through 42.)
- *Assessing the identified risks after taking into account an evaluation of the entity's programs and controls.* This section requires the auditor to evaluate the entity's programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation. (See paragraphs 43 through 45.)
- *Responding to the results of the assessment.* This section emphasizes that the auditor's response to the risks of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence (see paragraph 46). The section requires the auditor to respond to the results of the risk assessment in three ways:
 1. A response that has an overall effect on how the audit is conducted, that is, a response involving more general considerations apart from the specific procedures otherwise planned (See paragraph 50.)
 2. A response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed (See paragraphs 51 through 56.)
 3. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls (See paragraphs 57 through 67.)
- *Evaluating audit evidence.* This section requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the assessment. (See paragraphs 68 through 74.) It also requires the auditor to consider whether identified misstatements

may be indicative of fraud and, if so, directs the auditor to evaluate their implications. (See paragraphs 75 through 78.)

- *Communicating about fraud to management, the audit committee, and others.* This section provides guidance regarding the auditor's communications about fraud to management, the audit committee, and others. (See paragraphs 79 through 82.)
- *Documenting the auditor's consideration of fraud.* This section describes related documentation requirements. (See paragraph 83.)

SAS No. 99 also includes an exhibit, "Management Antifraud Programs and Controls: Guidance to Help Deter, Detect, and Prevent Fraud," which has been developed to assist auditors in obtaining an understanding of programs and controls established by management to mitigate specific risks of fraud, or that otherwise help prevent, deter, and detect fraud. SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.

.195 The AICPA has developed a Practice Aid titled *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*, which will be published by the end of 2002. The Practice Aid includes topics such as how the new SAS changes audit practice, characteristics of fraud, understanding the new SAS, best practices, and practice aids such as, specialized industry fraud risk factors, common frauds, and extended audit procedures. Auditors should be on the lookout for this new publication (see the section titled "Practice Aid *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guidance*" later in this Alert for more information).

SOP 02-1, Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code

.196 In May 2002 the ASB issued this SOP, which was developed to provide practitioners with guidance on performing agreed-upon procedures engagements that address annual claims prompt payment reports as required by the New Jersey Administrative Code. Practitioners should note that the engagement described in this SOP is designed only to satisfy the requirements of the Code. The procedures, as set forth in this SOP, are not necessarily appropriate for use in any other engagement.

Audit Guide Service Organizations: Applying SAS No. 70, as Amended

.197 This Guide (product no. 012772kk) provides guidance to service auditors engaged to issue reports on a service organization's controls that may be part of a user organization's information system in the context of an audit of financial statements. It also provides guidance to user auditors engaged to audit the financial statements of entities that use service organizations. Guidance on performing service auditors' engagements and using service auditors' reports in audits of financial statements is provided in SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended.

Audit and Accounting Guide Audits of State and Local Governments (GASB 34 Edition)

.198 This new Guide (product no. 012662kk) addresses the audits of basic financial statements and consideration of required supplementary information (RSI) and supplementary information other than RSI (SI) prepared in conformity with the new governmental financial reporting model required by GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, and its related pronouncements.

.199 The new Guide is to be effective for audits of a state or local government's financial statements for the first fiscal period ending after June 15, 2003, in which the government does apply or is required to apply

the provisions of GASB Statements No. 34 or No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. Earlier application will be encouraged if a government issues financial statements that apply GASB Statements No. 34 or No. 35 after the Guide is issued. The AICPA's 1994 Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)* (updated annually for conforming changes) will remain effective for audits of state and local governments for which the auditor is not required to apply or has not elected to early apply the provisions of the new Guide in accordance with its effective date provisions.

.200 The new Guide, like the previous Guide, applies to *all* state and local governmental entities. That scope requires an auditor to consult two guides when performing audits of governmental entities in certain industries. Specifically, the new Guide applies to public entity risk pools and hospitals and other health care providers, even though the audits of those entities also are subject to the guidance in the Audit and Accounting Guides *Audits of Property and Liability Insurance Companies* and *Health Care Organizations*, respectively. The new Guide explains how auditors of those entities should use the auditing guidance in both of the guides that apply to those entities. The new Guide also provides an expanded section on auditing public colleges and universities.

Practice Alert 02-2, *Use of Specialists*

.201 Auditors may encounter difficulty in determining the appropriate situations in which to use a specialist and, in those cases when a specialist is appropriately used, understanding the findings of the specialist. The purpose of Practice Alert 02-2 is to assist auditors in understanding their responsibilities both with respect to the use of specialists that have been engaged or employed by the audit client and the use of specialists engaged or employed by the audit firm.

Practice Aid, *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*

.202 In connection with the issuance of SAS No. 99, the AICPA has developed a Practice Aid to help practitioners implement the new fraud guidance. *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide* (product no. 006613). The Practice Aid includes such topics as:

- How the new SAS changes audit practice
- Characteristics of fraud
- Understanding the new fraud SAS
- Best practices
- Practice aids such as:
 - Specialized industry fraud risk factors
 - Common frauds and extended audit procedures

The Practice Aid presents valuable guidance in helping practitioners understand and implement SAS No. 99.

New Accounting Pronouncements and Other Guidance

.203 Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated With Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions</i>
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i> See the "New Auditing and Attestation Pronouncements Quality Control, and Other Guidance" section for more information.
SOP 01-5	<i>Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</i>
SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i>
Technical Practice Aids	<i>Software Revenue Recognition</i>
Questions & Answers	<i>FASB Statement No. 87, Employers' Accounting for Pensions</i>

.204 Of the pronouncements and other guidance listed in the previous table, those having particular significance to the insurance industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA literature, contact the member satisfaction center at (888) 777-7077 or go online at www.cpa2biz.com.

SOP 01-5, Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification

.205 This SOP amends SOP 94-5, SOP 94-1 and AICPA Auditing Interpretation No. 12, as a result of the completion of the National Association of Insurance Commissioners (NAIC) Codification of statutory accounting practices for certain insurance enterprises. This SOP is effective for annual financial statements for fiscal years ending on or after December 31, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements. If comparative financial statements are presented for fiscal years ending before December 15, 2001, the disclosure provisions of SOP 94-5 effective prior to this SOP apply to permitted statutory practices by the regulatory authority. See the "Recent Regulatory Developments" section of this Alert for more information on SOP 01-5.

SOP 01-6, Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others

.206 This SOP applies to any entity that lends to or finances the activities of others. For example, that arrangement may be a secured mortgage loan, an unsecured commercial loan or a financing arrangement that involves only extending credit to trade customers resulting in trade receivables. Those financing activities of all entities are included in the scope of this SOP. The SOP provides specific guidance for other types of transactions, such as securities purchases, for certain financial institutions listed in the scope paragraphs of the SOP. To the extent an entity is not considered such a financial institution, as described in those paragraphs, the other guidance provided is not applicable. In other words, only the guidance in this SOP related to the financial and lending activities is applicable for entities not considered to be financial institutions.

.207 SOP 01-6 reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by the AICPA Audit and Accounting Guides *Banks and Savings Institutions*, *Audits of Credit Unions* and *Audits of Finance Companies*. The SOP also explicitly incorporates mortgage companies, corporate credit unions, and certain activities of insurance companies in its scope. This SOP will be incorporated in a new AICPA Audit and Accounting Guide, which will supersede the three aforementioned Guides. The new Guide is expected to be issued during the second quarter of 2003. See the SOP for effective date and transition information.

On the Horizon

.208 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that may be relevant to your financial institution engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.209 The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed below. Readers should refer to information provided by the various standard-setting bodies for further information.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if available, your membership and subscriber number in the message.

Auditing Pipeline

New Framework for the Audit Process

.210 The ASB has exposed a suite of seven proposed SASs relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance the auditor's application of the audit risk model in practice by requiring:

- A more in-depth understanding of the entity and its environment, including its internal control, that would better enable the auditor to identify the risks of material misstatement in the financial statements and any steps the entity is taking to mitigate them.
- A more rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- A better linkage between the assessed risks of material misstatement and the nature, timing, and extent of audit procedures performed in response to those risks.

.211 The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*
- *Audit Evidence*, which will supersede SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)
- *Audit Risk and Materiality in Conducting an Audit*, which will supersede SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)
- *Planning and Supervision*, which will supersede "Appointment of the Independent Auditor" (AICPA, *Professional Standards*, vol. 1, AU sec. 310), and SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement (Assessing Risks)*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, which will supersede SAS No. 45, *Omnibus Statement on Auditing Standards—1983, section 313, "Substantive Tests Prior to the Balance-Sheet Date"* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and, together with the proposed SAS *Assessing Risks* will supersede SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319)
- *Amendment to SAS No. 39, Audit Sampling*

.212 In connection with this major initiative, the ASB and the International Auditing and Assurance Standards Board (IAASB) have formed a joint task force to develop these new standards jointly. These standards will represent a significant step toward converging U.S. and international auditing standards. The standard produced by this joint task force will form the basis for the ASB's U.S. standards. You should keep abreast of the status of these projects inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Accounting Pipeline

Exposure Draft on Loans and Certain Debt Securities Acquired in a Transfer (Formerly Known as Purchased Loans and Securities)

.213 AcSEC has issued an exposure draft of a proposed SOP titled *Accounting for Loans and Certain Debt Securities Acquired in a Transfer*. This proposed SOP considers whether Practice Bulletin (PB) No. 6, *Amortization of Discounts on Certain Acquired Loans*, continues to be relevant given a number of FASB pronouncements issued subsequent to PB No. 6. The proposed SOP excludes originated loans from its scope. A final SOP is expected to be issued during December 2002.

Consolidation of Certain Special-Purpose Entities

.214 The FASB has issued an exposure draft of a proposed Interpretation, *Consolidation of Certain Special-Purpose Entities*, of Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*. This proposed Interpretation would address consolidation by business enterprises of special-purpose entities (SPEs) to which the usual condition of consolidation described in ARB No. 51 does not apply because the SPEs have no voting interest or otherwise are not subject to control through ownership of voting interests. A final Statement is expected to be issued during the fourth quarter of 2002.

Amendment of FASB Statement No. 133 on Derivative Instruments and Hedging Activities

.215 The FASB has issued an exposure draft of a proposed Statement, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. This proposed Statement would amend the definition of a derivative in paragraph 6(b) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging*

Activities. This proposed Statement also would amend FASB Statement No. 133 for various decisions made as part of the Derivatives Implementation Group process. A final Statement is expected to be issued during the fourth quarter of 2002.

Exposure Draft on Nontraditional Long-Duration Contracts and Separate Accounts

.216 In July 2002, AcSEC issued for exposure, the draft SOP *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts*. The proposed SOP addresses the classification and valuation of liabilities as well as the disclosure for nontraditional annuity and life insurance contracts issued by insurance enterprises. It also discusses the classification, valuation, and disclosure of assets held in separate accounts of insurance enterprises.

.217 A final SOP would be effective for financial statements for fiscal years beginning after December 15, 2003, with earlier adoption encouraged. The SOP may not be applied retroactively to prior years' financial statements, and initial application should be as of the beginning of an entity's fiscal year. The exposure draft had 90-day comment period that ended October 31, 2002, and is available on the AICPA Web site at www.aicpa.org. AcSEC will begin discussing comment letters received at its December 2002 meeting.

Accounting for Deferred Acquisition Costs on Internal Replacements

.218 In July 2000, AcSEC's Planning Subcommittee approved a prospectus for an SOP project to provide authoritative guidance on accounting by life insurance enterprises for deferred acquisition costs on internal replacements other than those covered by FASB Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*. The FASB cleared the prospectus in November 2000. The task force has met several times with AcSEC and it is expected that an exposure draft will be issued during the first quarter of 2003.

Accounting for Purchase Business Combinations Involving Insurance Enterprises Including Certain Reinsurance Transactions That Are in Substance Business Combinations

.219 In September 2001, AcSEC's Planning Subcommittee approved a prospectus, subject to FASB clearance, of a project to develop a SOP that will provide guidance on how to apply FASB Statements No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets*, and the conclusions of the FASB Business Combinations II Project: *Applying the Purchase Method* (Business Combinations II) for purchase business combinations involving enterprises that issue short-duration and/or long-duration contracts as within the scope of FASB Statements No. 60, No. 97, No. 113, and No. 120.

.220 In May 2002, the FASB cleared the prospectus with the understanding that the AcSEC task force would work in tandem with the FASB's conclusions on these projects.

Resource Central

Education courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

.221 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- Audit and Accounting Guide *Life and Health Insurance Entities* (product no. 012632kk)
- Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* (product no. 012672kk)

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 123520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit and Accounting Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012541kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques*—2002
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Audit Risk Alert *E-Business Industry Developments*—2002/03 [AAM section 8210]

Audit and Accounting Manual

.222 The *Audit and Accounting Manual* (product no. 005132kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditor's reports, checklists, and engagement letters; management representation letters; and confirmation letters.

AICPA reSOURCE Online: Accounting and Auditing Literature

.223 Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, all Audit and Accounting Guides, all Audit Risk Alerts, and *Accounting Trends & Techniques*. To subscribe to this essential online service, go to cpa2biz.com.

Education Opportunities

.224 The AICPA has developed a number of continuing professional education courses that are valuable to CPAs working in the insurance industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (product no. 737062kk [text] and 187080kk [video]). Whether you are in industry or public practice, this course keeps you current, informed, and shows you how to apply the most recent standards.
- *Fair Value Accounting for Hedge Transactions* (product no. 735181). This course helps you understand GAAP for derivatives and hedging activities. Also, you will learn how to identify effective and ineffective hedges.
- *SEC Reporting* (product no. 736746). This course will help the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.
- *E-Commerce: Controls and Audit* (product no. 731550kk). This course is a comprehensive overview of the world of e-commerce. Topics covered include internal control evaluation and audit procedures necessary for evaluating business-to-consumer and business-to-business transactions.

Online CPE

.225 The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee (\$95 for members and \$295 for nonmembers) provides unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

CPE CD-ROM

.226 *The Practitioner's Update* (product no. 738450kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

.227 To order AICPA products, receive information about AICPA activities, and find help on your membership questions call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.228 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.229 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.

Web Sites

AICPA Online and CPA2Biz

.230 AICPA Online, at www.aicpa.org, offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the Professional Standards, and CPE courses.

Other Helpful Web Sites

.231 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of this Alert.

.232 This Audit Risk Alert replaces the *Insurance Industry Developments—2001/02* Audit Risk Alert. The *Insurance Industry Developments 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 e-mail these comments to jgould@aicpa.org, or write to:

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Information Sources

Organization	General Information	Fax Services	Internet	Recorded Announcements
American Institute of Certified Public Accountants (AICPA)	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 www.cpa2biz.com	AcSEC Telephone Line (212) 596-6008
Financial Accounting Standards Board (FASB)	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
Financial Crimes Enforcement Network (FinCEN)	2070 Chain Bridge Road Vienna, VA 22182 (703) 905-3770		www.ustreas.gov/fincen	
National Association of Insurance Commissioners (NAIC)	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 (GAO)	Superintendent of Documents U.S. Government Printing Office Washington, D.C. 20401-0001 (202) 512-1800	Information Line (202) 512-2250	www.gpo.gov	
U.S. Securities and Exchange Commission (SEC)	Publications Unit 450 Fifth Street, NW Washington, D.C. 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

Banks, Credit Unions, and Other Lenders and Depository Institutions Industry—2002/03

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your audits of financial institutions and other lenders. This Alert delivers knowledge to assist you in achieving a more robust understanding of the business environment your clients operate in. This Alert is an important tool in helping you identify the significant business risks that may result in the material misstatement of financial statements. Moreover, this Alert delivers information about emerging practice issues and about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the financial institution industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining and understanding that industry knowledge.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

Industry and Economic Developments

The Economy: From “Neutral” to “Weakness”

.04 Note: See the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] for additional information about the U.S. and international economies.

.05 On September 24, 2002, the Federal Reserve Board (FRB) chose to hold short-term interest rates constant at 1.75 percent, the lowest rate in 41 years. This rate has remained unchanged throughout 2002 in response to first and second quarter annual growth rates of 5 and 1.1 percent, respectively. Additionally, on September 24, the 10-year treasury yield curve was 2.04 basis points, flattening from 2.79 basis points on July 24, 2002. In its most recent meeting, the Federal Reserve officially said the economy is moving “towards weakness” rather than staying “neutral,” and there is talk of a potential rate decrease during the fourth quarter in order to stimulate the economy.

.06 The central bank opted not to cut rates because it still expects the economy to keep growing in fits and starts. Unfortunately, the nation’s economic recovery is weaker than previously believed. The Department of Commerce has made extensive revisions to 2001 data, most notably indicating that the 2001 recession was longer and deeper than previously thought. The economy shrank in each of the first three quarters instead of just the third, thus raising the expectation that the still-fragile recovery could stall.

.07 The stock markets since September 11 have broken down, due to various reasons including corporate governance issues. The costs of corporate borrowing have been sharply driven up, making it difficult for all but the most creditworthy corporations to borrow.

.08 Additionally, capital spending has suffered. Capital spending remains a major sector even in our predominantly service-oriented economy. Financial institutions are tightening lending standards for their customers, thus limiting the amount of money available to spend on capital investments. In addition, corporate executives are afraid to take on inventory during these uncertain times. The United States economy will not improve significantly until capital spending picks up again.

.09 Government statistics revealed fresh signs of weakness in key sectors of the economy, including commercial real estate and government spending. Finally, investors have been more susceptible to worries about terrorism and potential global conflict. Recent U.S. warnings about an attack on Iraq have added to stock market volatility and have added additional uncertainty to the economy.

Financial Institutions and the Economy

.10 ***Consumer Lending.*** The low interest rate policy has brought down mortgage rates, spurring home sales and enabling many households to refinance and improve their cash flow, while making it possible for automakers and dealers to offer no-interest loans. These factors have helped some financial institutions post record numbers of loans to customers and increase income from loan securitizations. However, one of the problems in the so-called “recovery” of 2002 is that corporate earnings are not keeping pace with the economic recovery. Consumers know this and are wary of borrowing and investing, except in areas such as real estate.

.11 Housing activity accounted for nearly one-half of the 1.2 percent gain in real gross domestic product in 2001. Ordinarily, housing activity slows during a recession. But last year, sales increased because of extraordinarily low interest rates, aggressive mortgage lending, and the sharp sell-off in the stock market, which left many searching for safer investments. The housing market is blocking the recent recession from hitting many major metropolitan areas, although housing’s benefits to the economy could ease in the months ahead. Housing prices are rising at a rate many economists believe is unsustainable, meaning some cities could experience a price correction. So while the current loan boom has made the financial institution industry one of the strongest in today’s weak economy, a housing market bust could soon have the opposite effect on financial institutions by impairing assets and decreasing revenues.

.12 Note that in the third quarter of 2002, foreclosures reached high levels as many consumers stopped making mortgage payments. The layoffs of 2001 are the main culprit. Certain financial institutions have been encountering cash flow problems due to an increase in consumer default on credit card debt. Smaller lenders with a higher percentage of credit card portfolios will be more adversely affected. Additionally, the Federal Deposit Insurance Corporation (FDIC) noted that *subprime* lenders consistently underestimated losses in 2001. The federal banking agencies have continued to struggle with defining subprime and have come up with some definitions that would suggest that nearly half of U.S. family mortgages may be subprime. Institutions may need to adjust their credit risk models to better reflect economic conditions.

.13 ***Commercial Lending and Bankruptcy.*** A number of major industry players in the commercial lending sector are incurring lower earnings attributable to higher loan loss provisions for nonperforming loans. Many loan writeoffs already recorded have occurred because of corporate bankruptcies. Also, a number of institutions have incurred losses related to syndicated loans made to companies experiencing financial difficulties. For additional information, see “Commercial Lending” in the “Credit Risk Watch” section of this Alert.

.14 ***Internal Management.*** Finally, financial institutions have experienced high management turnover due to layoffs and corporate governance issues. Controls over other areas, such as lending and collections, could also suffer. Turnover can have a serious effect on a financial institution’s internal control and financial reporting and accounting systems. Key unfilled positions and lack of qualified employees corrode controls. You may want to consider these risk assessment issues while planning and performing the audit. Gaps in

key positions may cause control weaknesses representing reportable conditions that should be communicated to management and the audit or supervisory committee in accordance with 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), and SAS No. 90, *Audit Committee Communications* (AICPA, *Professional Standards*, vol. 1, AU secs. 380 and 722).

.15 The federal banking regulatory agencies have issued warnings to financial institutions over the last several years to the effect that the agencies may have safety and soundness concerns if regulated banks scale back their auditing without sufficient controls in place to compensate for the changes.

.16 In addition, new legislation has been put into effect this year due to corporate governance issues. For a complete discussion of corporate governance, the U.S. business environment and the economies of foreign nations, see the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

M&A Report 2002

.17 Mergers and acquisition (M&A) activity slowed considerably in 2002. Instead of buying, many institutions started to improve themselves internally, working toward goals set in past acquisitions. Often, that meant selling, closing, or spinning off less desirable units instead of expanding.

.18 There are a number of reasons for the slowdown. First, banks and other financial stocks were depressed for much of the year, making it difficult for potential buyers to engage in the stock for stock deals that financial institutions prefer. Commercial loan troubles emerged during 2001 and damaged target companies' stocks as merger currency. Some banks had major credit issues as well.

.19 Second, asking prices for some companies remained unrealistically high, blocking potential mergers. Finally, unfamiliarity with accounting procedures introduced by accounting reforms has slowed down mergers. Remember, the pooling of interest method was eliminated on June 30, 2001, except for combinations between two or more mutual enterprises.

.20 In response to the market, analysts have downgraded some investment banks. Additionally, investors have taken a more conservative stance on earnings per share growth for the remainder of 2002 and 2003, given the market declines and the low levels of merger, acquisition, and equity underwriting activity.

.21 The exception to the slowdown has been in the middle market mortgage lender sector, particularly when mortgage units have been a good source of revenue for the parent. The area of mortgage servicing is also ripe for consolidation.

Sarbanes-Oxley Act of 2002

.22 On July 31, 2002, the Sarbanes-Oxley Act of 2002 (the Act) was signed into law. In remarks at the White House signing ceremony for the Act, President Bush declared, "the era of low standards and false profits is over; no boardroom in America is above or beyond the law. This law says to corporate accountants: the high standards of your profession will be enforced without exception; the auditors will be audited; the accountants will be held to account."

.23 This Act is one of the most far-reaching pieces of legislation ever to address corporate fraud and public accounting. Support for the law was fueled by multiple reports of corporate accounting scandals, defrauded investors, and a plummeting stock market.

.24 See the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] for further information about the Sarbanes-Oxley Act.

.25 The scandals leading to the passage of the Act brought to light numerous conflicts of interest inherent in the business model of some major Wall Street institutions, which served in many conflicting capacities in their dealings with Enron. They acted as lenders, advisers and underwriters for Enron while also managing assets for the energy company and its executives and investors. Now, investigators in the Enron case have recently switched their attention from accountants to financial institutions and the role they played in the rise and fall of the company. Congress, the Securities and Exchange Commission (SEC), and the Justice Department are questioning three of the largest financial firms—Citigroup Inc., J.P. Morgan Chase & Co, and Merrill Lynch & Co.—about financing they provided to Enron. The investigators are examining whether the firms helped Enron artificially increase earnings by structuring transactions in a way that allowed the energy concern to disguise loans as trades and hide debts in special-purpose entities (SPEs).

.26 *Congressional.* Hearings may be held on the adequacy of bank regulatory oversight and the possible role of investment and commercial banks in facilitating fraudulent accounting practices and other abuses. Additionally, Section 705 of the Sarbanes-Oxley Act requires the Comptroller General to conduct a study on whether investment banks and financial advisers assisted public companies in manipulating their earnings and obfuscating their true financial condition. Among other things, the study will address the role the financial institutions played in the collapse of Enron. Upon the completion of the study, the Comptroller General will issue a report discussing regulatory or legislative steps that are recommended or that may be necessary to address concerns identified in the study.

Denser Derivatives

.27 The growing number of corporate scandals fueled increased activity in derivative contracts that commercial banks held for themselves and their customers. The largely unregulated derivative market has ballooned this year. Responding to pressure to mitigate risk, risk managers typically responded by reshaping their risk profiles, which drove up derivative notional volumes during the second quarter of 2002.

.28 Remember that when entities lose money on derivative contracts, the writeoffs usually occur some time after the contract goes sour. Also, auditors should watch out for embedded derivatives including those related to convertible debt and callable notes. SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards* vol. 1, AU sec. 332), along with its companion Audit Guide, provides specific guidance on auditing derivatives.

Back on the Balance Sheet Again

.29 A large portion of off-balance-sheet debt could return to the balance sheets of financial institutions and their customers as a result of changes in accounting principles and possible legislative and regulatory action. The FASB currently has a project in the works that would amend the way SPEs are reported on. This project, expected to be finalized by the end of 2002, would have a major impact on financial institutions. See a description of the FASB's work in this area in the "On the Horizon" section of this Alert.

Credit Risk Watch

Asset-Liability Management

.30 The rate environment for all financial institutions has been changing drastically over the past few years. In 2001, the FRB cut rates nine times, for a total of 450 basis points. The short-term rate was 2.0 percent in October 2001 and has remained at 1.75 percent throughout the first three quarters of 2002, the lowest level in 41 years. Prior to 2001, the opposite was occurring and the Fed had raised rates six times over a period of twelve months. In 1999–2000, many financial institutions had high loan demand and it was difficult for institutions to maintain deposits. In 2001, the opposite occurred. Loan growth slowed and institutions could hardly keep the deposits away. The public began to shift savings from equities into institutions, and some

institutions such as credit unions were much slower than others in lowering their share rates, which caused shares to grow even more and net margins to shrink.

.31 Of course, no one could predict the dramatic changes that have occurred. What is important to recognize is that dramatic swings will continue to occur and have tremendous impact on a financial institution's earnings, liquidity, margins, share and loan demand, and asset values. It is essential that management plan for these changes. Solid asset liability management procedures, financial planning, and investment strategy come into play. With proper planning and solid policies and procedures in place, institutions can manage these changes, and properly assess the impact of alternative actions. Without proper planning, there exists serious risk of financial problems, including unnecessary losses and declines in asset values.

.32 Whether the financial institution has an in-house asset liability management program or has outsourced asset liability management (ALM) to an outside vendor, it is important that management and the board of directors understand the ALM program and its results. If the institution has an in-house program, management needs assurance that the program is run correctly. If an outside ALM vendor is used, management needs to understand the vendor's modeling results and the assumptions used. The degree of sophistication needed will vary with the complexity of the balance sheet.

.33 ALM programs can be complex and require sophisticated assumptions to be properly run. Personnel running ALM programs may not fully understand the intricacies of the model or may not have developed reasonable assumptions to produce reasonable results. Therefore, financial planning may be based on faulty premises and data. A couple of typical examples of ALM modeling errors include the following:

- *Inaccurate or unreliable prepayment assumptions.* Has the institution established prepayment assumptions in the model? Are the assumptions reasonable and periodically updated? Do prepayment speeds change with interest rates? Does management know what the prepayment assumptions are? If the answer to any of these questions is no, the ALM model's output may be suspect.
- *No core deposit or decay rates.* Decay rates are the assumed maturity of nonmaturity deposits. If decay rates are not reasonable then the model results will not be reliable.
- *Inaccurate input of data.* Detail reports should be run to review the data for errors in the way the model is run and to determine whether the data have been inaccurately input into the model. One basic test is to compare the model results with actual history.

.34 Management needs to ensure that any ALM modeling is performed reasonably and accurately.

.35 In the current low-interest rate environment, financial institutions need to be diligent in their financial management process and thoroughly aware of financial and interest rate risks. Along with an increase in deposits, institutions that have large investment portfolios of callable securities have seen an influx of additional funds as securities are or were called. With excess liquidity and low investment rates, there may be a desire to obtain high-risk investment products. Each institution needs to carefully evaluate its investment and financial decisions.

Commercial Lending

.36 There are five commercial real estate sectors, namely, office, hotel, industrial, multifamily, and retail. Commercial real estate lending is highly cyclical, and all segments have been adversely affected to some extent by the economic slowdown. Largely as a result of the deflation of high tech, there is a significant amount of available subleased office space which is negatively affecting this sector. Additionally, space reductions at blue chip companies as well as major bankruptcies have hurt the commercial lending sector. On the positive side, the hotel sector, despite being heavily affected by the terrorist attacks, has shown quicker signs of recovery.

.37 Unfortunately, the volume of commercial lending at banks has declined this year. Additionally, banks received just 55 cents in recoveries on every dollar of defaulted loans last year, far below the historical average of 69 cents. The overall reduction in the demand for external financing is also due to financial institutions imposing stricter underwriting standards and higher fees and spreads on backup lines of credit for commercial loans because institutions are concerned about the lines being tapped and the overall creditworthiness of customers. Institutions have not been as strict with smaller businesses. However, lenders will remain skeptical of large corporate borrowers with complex balance sheets.

Consumer Loan Credit Scoring and Risk-Based Lending

.38 The use of credit scores as a tool in the loan approval decision process has grown considerably over the past few years. Scores include the FICO (Fair Isaac Company) and Beacon. In addition, many financial institutions have developed internal credit scoring programs. As loan decisions become more automated, financial institutions are using credit scores to a greater extent to approve and determine the interest rate for consumer loans. Traditional underwriting and evaluations of customers' credit capacity are often relied on to a lesser extent, as credit scores become the predominant factor in the loan approval decision process. The auditor and management should thoroughly understand the impact of the credit scores in evaluating expected loan losses.

.39 Assurance should be gained that the scoring system in use is reliable and has been properly validated. This should be done for both external systems and internally developed credit scoring systems. Management must have the capability to properly estimate the expected performance of each category of credit scores. System controls should be in place to capture and report relevant credit scoring information, including the ability to monitor performance by credit scores.

.40 Another lending tool or system that has grown considerably is the use of risk-based lending (RBL) or pricing programs. RBL programs are becoming increasingly common in many financial institutions. RBL refers to pricing different categories of loans according to the risk or probability of default. Not all borrowers are viewed as equals, but rather, loans are made and priced according to the borrower's credit. Usually, an applicant's creditworthiness is rated in conjunction with a credit scoring system. The result is greater loan volume and greater overall portfolio returns because the institution can better price loans in accordance with risk, expand its customer and loan base, and reach more underserved customers who may otherwise be declined. Even though RBL programs can serve as a valuable program and resource and help the financial institution meet expanding competitive pricing constraints, the programs also present substantial new risks of losses and compliance concerns.

Common Credit Scoring and Risk-Based Lending Control Weaknesses

.41 Some common pitfalls and control weaknesses with credit scoring and risk based pricing/lending programs that could potentially result in material losses and other problems include the following:

- A greater number of high-risk loans than intended
- Inadequate reporting mechanisms to alert management and the board of potential problems
- Lack of personnel training and lack of management understanding concerning credit scoring and risk-based lending
- Old or outdated scoring models and a lack of validations and revalidation resulting in faulty loan approval and pricing decisions
- Inadequate risk management procedures and inadequate risk management staffing
- Inadequate operational risk controls and monitoring that result in substantially greater risk to the institution than was expected given a particular score

- Incomplete policies and procedures covering both risk based lending and credit scoring
- Inefficient use of databases, purging of data, and lack of controls covering data entry
- Inconsistent decisions and excessive overrides of scores
- Errors in calculations of scores and rates; system parameters established incorrectly and with lack of proper knowledge and control
- Improper pricing of risk tiers
- A lack of knowledge and information on the profitability of the individual risk tiers
- Incomplete monitoring of scoring and RBL

.42 The auditor may need to determine that the financial institution has established a reasonable control environment for its RBL and that it has properly addressed any regulatory advisories and requirements. An understanding should be gained of the potential effect of higher risk loan categories on loan losses and the allowance for loan losses.

Interesting Mortgages

.43 While no one could picture any year surpassing the mortgage boom of 2001, analysts are now predicting that 2002 will exceed the prior year's millennium mortgage madness. Mortgage interest rates have spiraled down to those existing during the Eisenhower years. This is not surprising, as history shows that strong housing markets follow strong stock markets by approximately two years.

.44 It is possible that interest rates will hit bottom by the end of 2002. Many institutions now hold many long-term, fixed-rate mortgages in an effort to keep net interest margins from falling further than they have this year. Therefore, the refinance boom has left many institutions with high concentrations of fixed-rate, 15- and 30-year mortgages because consumers like to lock in long-term low rates during a decline. Markets for variable rates have suffered.

Some Audit Considerations

.45 You may need to consider whether the institution has adequate asset liability management procedures in place to understand and manage its market and liquidity risk in a falling interest rate environment. Institutions now have asset heavy portfolios on their books that have been hard to sell during the low rate economy. These assets are risky for two reasons. First, since financial institutions lend long term and borrow short term, the asset/liability balance will be detrimental when the cost of borrowing increases during a rise in rates. (Many long-term assets are now locked in at rates unheard of two years ago). Second, overvalued home appraisals during the current housing market boom may lead to the receivables and foreclosed assets themselves being overvalued.

.46 Additionally, voluminous low-interest-rate refinancing will affect a lender's operations and earnings. Profits may suffer substantial decline and could lead to going-concern implications. Also, a lender's management will probably experience intense pressure from stakeholders to maintain profitability, thereby increasing the institution's risk of fraud.

.47 While many of the refinances are being made into fixed rate mortgage loans, there are still a significant number of borrowers opting for the even lower initial rates of adjustable rate mortgages (ARMs). Because of the very low initial rates being offered on these ARMs, it is very likely that future rate increases may push the interest rates on these loans up 5 percentage points or more. Underwriting standards need to consider the likelihood of such increases even more seriously because of the historically low current rates.

.48 Although the loan origination and servicing fee revenues earned may increase due to an influx of new customers, as interest rates decline, margins may correspondingly decrease. Institutions are subject to

prepayment risk in falling rate environments. Mortgage loans and other receivables may be prepaid by a debtor, so the debtor may refinance its obligations at new, lower rates. If an institution does not have an effective system for generating new mortgage loans in a period of significant prepayments, the institution's future prospects may be negatively affected. Prepayments of assets carrying the old, higher rates reduce the institution's net income and overall asset yields. In addition to loans, other items such as securities, deposits, debts, and derivatives all depend on interest rates.

.49 Finally, many loans have been refinanced. Second-mortgage lenders rank below first-lien holders in collection efforts, and the holder of the second lien is not able to collect until the first lender has been paid. Therefore, one should note the creditor status of the client's portfolio base.

Loan Loss Allowance Update

.50 As stated earlier, the grim economic picture seriously heightens concerns about credit quality. As business earnings plunge and layoffs occur, loan delinquencies and defaults may increase sharply. Moreover, the quality of an institution's loan portfolio may deteriorate. Institutions may have eased their underwriting standards in 2001 to attract additional customers during the antecedent economic growth period. Management and auditors need to be especially alert during these poor economic times to ensure that loan loss allowances are adequate and impaired loans are properly accounted for.

.51 During 2002, weaknesses are beginning to appear at banks, especially in credit-card portfolios. In the first quarter of 2002, non-performing loans at many financial institutions continued to increase and as a result, reserves increased in the first quarter. However, the increase in non-performing loans meant that some institutions are now not meeting industry coverage ratios. Additionally, the problems in the telecommunications and energy sectors have led to bankruptcies and bad loans for banks. Despite tightening credit standards toward commercial enterprises, many institutions will need to increase allowances. Estimates show that loan losses will continue to grow until at least the third quarter of 2003.

.52 When evaluating credit risk, the quality of loans, and the adequacy of loan loss allowances, auditors should consider the matters discussed in this Alert and determine whether there is a heightened level of audit risk. If so, it may be necessary to alter the nature, timing, and extent of audit procedures and to increase the level of testing. The evaluation of loan quality and loss allowances can be a complicated process, and the following specific literature will aid you in the accounting and auditing process. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and the AICPA Practice Aid entitled *Auditing Estimates and Other Soft Accounting Information* provide guidance on auditing estimates.

National Credit Union Administration Interpretive Ruling and Policy Statement 02-3 on the Allowance for Loan and Lease Losses

.53 This interpretive ruling and policy statement (IRPS), issued on May 28, 2002, provides guidance on the design and implementation of Allowance for Loan and Lease Losses (ALLL) methodologies and supporting documentation practices for credit unions. It provides guidelines that are very similar to the recently issued interagency policy statements of the four federal banking agencies published on July 6, 2001, and similar federal banking guidance issued by the SEC in Staff Accounting Bulletin (SAB) No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*.

.54 The IRPS was developed in consultation with the other federal banking agencies and the SEC. It provides guidance on the design and implementation of significant aspects of ALLL methodologies and supporting documentation practices. As stated in National Credit Union Administration (NCUA) letter 02-CU-09, the IRPS also includes illustrations of implementation practices that credit unions may find useful for enhancing their own ALLL as well as explanations and guidance on generally accepted accounting principles (GAAP) and regulatory statements addressing the ALLL.

.55 The IRPS does not change the existing accounting guidance in or modify the documentation requirements of GAAP. It is intended to supplement not replace current guidance. The IRPS does not address or change current guidance concerning loan chargeoffs.

.56 As with the banking Policy Statement, the IRPS specifically addresses the following concerns:

- It clarifies that the board of directors of each institution is responsible for ensuring that controls are in place to determine the appropriate level of the ALLL.
- It states that the ALLL process must be thorough, disciplined and consistently applied, and must incorporate management's current judgments about the credit quality of the loan portfolio.
- It emphasizes the NCUA's long-standing position that institutions should maintain and support the ALLL with documentation that is consistent with their stated policies and procedures, GAAP, and applicable supervisory guidance.
- It provides guidance on maintaining and documenting policies and procedures that are appropriately tailored to the size and complexity of the institution and its loan portfolio.
- Because credit unions are currently required to follow GAAP regarding methodologies and documentation for the ALLL, the IRPS should not significantly affect calculation methodologies.

However, it should serve to clarify and improve practices and procedures, which the auditor will want to review for compliance with GAAP and the IRPS. For example, the institution will be required to ensure that the ALLL policies are current and adequately address the specific policy requirements in the IRPS and Policy Statement.

.57 The auditor should be aware of the potential impact of changing economic conditions and changes in the institution's lending products and practices on the institution's ALLL methodologies. Many credit unions have implemented a variety of both new lending practices and programs within the last couple of years. These programs must be addressed in the ALLL methodologies. For example, some credit unions recently have implemented new business or commercial lending programs. ALLL methodologies that previously relied on FASB Statement of Financial Accounting Standards (Statement) No. 5, *Accounting for Contingencies*, for loans evaluated on a group basis, may now be required to follow FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, for evaluating impairment and losses on individual loans. Some examples of other programs and factors that may require a reevaluation of existing ALLL methodologies include indirect vehicle lending, risk-based lending, subprime programs, current economic conditions, new credit scoring or other loan approval technologies, and changes in membership or customer demographics.

.58 The IRPS and policy statements point out that while different institutions may use different methods, certain elements should be in any ALLL methodology including the following:

1. A detailed analysis of the loan portfolio, performed on a regular basis
2. Consideration of all loans (whether on an individual or group basis)
3. Identification of loans for impairment analysis on an individual basis under FASB Statement No. 114 and the segmentation of the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation under FASB Statement No. 5
4. Consideration of all known relevant internal and external factors that may affect loan collectibility
5. Consistent application of loan collectibility factors, with modification for new factors that may affect collectibility
6. Consideration of the different risks inherent in different kinds of lending

7. Consideration of current collateral values where applicable
8. Performance of analysis, estimates, reviews, and all other ALLL methodology functions by competent and well-trained personnel
9. Methodology that is based on current and reliable data
10. Methodology that is well documented with clear explanations of the supporting analyses and rationale
11. A systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with GAAP

Other Accounting and Auditing Considerations

FASB and AICPA Guidance

.59 Currently, the accounting guidance for the measurement of the allowance for loan losses available to financial institutions is addressed in FASB Statements No. 5, and No. 114, as amended by FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures*; EITF Topic D-80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio*; FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (an Interpretation of FASB Statement No. 5); and the AICPA Audit and Accounting Guides *Banks and Savings Institutions*, *Audits of Credit Unions*, and *Audits of Finance Companies*.

.60 *The FASB Viewpoints Article on Loan Loss Allowances.* The April 12, 1999, issue of FASB *Viewpoints* addressed the application of FASB Statements No. 5 and No. 114 to a loan portfolio and discussed how those Statements interrelate. The *Viewpoints* article discusses numerous issues, including the following questions:

- How should a creditor identify loans that are to be individually evaluated for collectibility under FASB Statement No. 114?
- How should a creditor determine whether it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan agreement under FASB Statement No. 114?
- If a creditor concludes that an individual loan specifically identified for evaluation is not impaired under FASB Statement No. 114, may that loan be included in the assessment of the allowance for loan losses under FASB Statement No. 5?

The FASB *Viewpoints* publication can be obtained at the FASB Web site at www.fasb.org.

.61 *SOP 01-6.* Financial institutions and auditors also need to follow the guidance in SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*. For example, the arrangement may be a secured mortgage loan, an unsecured commercial loan, or a financing arrangement that only involves extending credit to trade customers resulting in trade receivables.

.62 For banks and savings institution recognition and measurement, note that all sales of servicing rights should be recognized into income, regardless of whether the loan is retained or sold. Additionally, insurance commissions need to be amortized over the insurance risk period for experience-rated or retrospective commission arrangements.

.63 As with banks and savings institutions, recognition and measurement is of critical importance to credit unions as well. For example:

- Standby commitments to purchase loans should be either reported as a net against loans purchased and amortized under FASB Statement No. 91, or recorded as liabilities (the greater of the fair market value or the fee received.)

- Nonmortgage loans held for sale should be recorded at the lower of cost or market.
- Short sales of securities (securities sold, not yet purchased) should be a liability at fair value.
- A liability should be recorded when the credit union receives member deposits, not when funds are collected.
- Redeemable preferred stock dividends should be recorded based on their preferred stock classification.

.64 SOP 01-6 contains numerous presentation and disclosure requirements that apply to the financial statements. Additionally, SOP 01-6 removes some disclosure requirements for banks and credit unions. Banks no longer need to disclose balance-sheet presentation of cash and cash equivalents, interest-bearing deposits, federal funds purchased, and repurchase agreements. Additionally, the requirement for regulatory capital long-term debt disclosure has also been removed.

.65 For credit unions, SOP 01-6 eliminates the following requirements:

- Disclosure of significant factors affecting the carrying amount of mortgage related derivative securities
- Disclosure of additional information about repurchased and reverse repurchased agreements apart from FASB Statement No. 107
- Disclosure of additional information about servicing apart from FASB Statement No. 140
- Disclosure of additional information about credit union deposits

.66 Readers should refer to the full text of SOP 01-6 when evaluating lending and financing activities. SOP 01-6 reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by the AICPA Audit and Accounting Guides *Banks and Savings Institutions*, *Audits of Credit Unions*, and *Audits of Finance Companies*. This SOP will be incorporated in a new AICPA Audit and Accounting Guide, which will supersede the three aforementioned Guides. The new Guide is expected to be issued during the second quarter of 2003. See the SOP for effective date and transition information.

.67 **SOP 94-6.** Financial institutions and auditors also need to follow the guidance in SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

.68 More specifically, SOP 94-6 requires entities to disclose certain concentrations (described in paragraph 22 of the SOP) if, based on information known to management before issuance of the financial statements, all of the following criteria are met:

- The concentration exists at the date of the financial statements.
- The concentration makes the entity vulnerable to the risk of a near-term severe impact.
- It is at least reasonably possible that the events that could cause the severe impact will occur in the near term.

.69 Examples of concentrations that might be found at financial institutions include:

- Sale of a substantial portion of or all receivables or loan products to a single customer
- Loss of approved status as a seller to or servicer for a third party
- Concentration of revenue from issuances involving a third-party guarantee program
- Concentration of revenue from mortgage banking activities

.70 **AICPA Audit and Accounting Guides.** Auditors should read SOP 01-6 in conjunction with 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.

Regulatory Guidance

.71 SEC Financial Reporting Release (FRR) No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*, issued in December 1986, states that the books and records of registrants engaged in lending activities are expected to include documentation of a systematic methodology to be employed each period in determining the amount of loan losses to be reported and the rationale supporting each period's determination that the amounts reported were accurate. Also note that FRR No. 28 requires registrants to describe their procedural discipline in the business section of the annual report.

.72 Additionally, the Interagency Policy Statement on the Allowance for Loan and Lease Losses (Interagency Policy Statement) issued on December 21, 1993, by the SEC and the federal banking regulators requires nonpublic financial institutions to follow instructions very similar to those outlined in FRR No. 28.

.73 Even though the allowance for loan loss documentation requires numerical calculations, it is critical that financial institutions have written, qualitative narrative supporting the thought process behind the calculations in satisfying the procedural discipline required by FRR No. 28. Moreover, financial institutions should maintain a self-correcting mechanism that adjusts loss estimation methods in order to reduce differences between estimated and actual observed losses.

.74 **SEC SAB No. 102.** On July 6, 2001, the SEC released SAB No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*, which provides certain views of the staff on the development, documentation, and application of a systematic loan loss allowance methodology in accordance with GAAP as required by FRR No. 28. In particular, the guidance focuses on the documentation the staff normally would expect registrants to prepare and maintain in support of their allowances for loan losses. The SAB applies to registrants that are creditors in loan transactions that, individually or in the aggregate, have a material effect on the registrant's financial statements.

.75 **Federal Financial Institutions Examination Council Guidance.** In conjunction with the release of SAB No. 102, the Federal Financial Institutions Examination Council (FFIEC) issued on July 6, 2001, an Interagency Policy Statement entitled *Allowance for Loan Loss and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions*.

.76 The Interagency Policy Statement provides guidance on the design and implementation of ALLL methodologies and supporting documentation practices. Specifically, the statement:

- Clarifies that the board of directors of each institution is responsible for ensuring that controls are in place to consistently determine the appropriate level of the ALLL.
- States that the ALLL process must be appropriate, systematic, and consistently applied, and must incorporate management's current judgments about the credit quality of the loan portfolio.
- Emphasizes the banking agencies' long-standing position that institutions should maintain and support the ALLL with documentation that is consistent with their stated policies and procedures, GAAP, and applicable supervisory guidance.
- Provides guidance on maintaining and documenting policies and procedures that are appropriately tailored to the size and complexity of the institution and its loan portfolio.

.77 The Interagency Policy Statement also includes illustrations of implementation practices that institutions may find useful for enhancing their own ALLL processes; an appendix that provides examples of

certain key aspects of ALLL guidance; a summary of applicable GAAP guidance; and a bibliographical list of relevant GAAP guidance, joint interagency statements, and other literature on ALLL issues.

.78 The Interagency Policy Statement does not change existing accounting guidance in or modify the documentation requirements of GAAP or guidance provided in the relevant joint interagency statements. The text of the full document is located at the FDIC Web site at www.fdic.gov.

.79 *Interagency Guidance Points Out Important Practices.* A joint interagency letter (issued July 12, 1999) reaffirmed aspects of loan loss allowance practices. This letter was issued by the SEC, the FDIC, the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

.80 *Disclosures Related to Loan Loss Allowances.* Management's discussion and analysis (MD&A) and SEC Industry Guide 3 disclosures need to fully disclose all pertinent trends, events, and uncertainties related to the allowance for loan losses. Moreover, the narrative disclosures in MD&A need to be consistent with the MD&A financial tables relating to the allowance for loan losses and loan portfolio, and with the financial statements and related footnotes.

.81 The discussion in MD&A should be in quantified detail, explaining the changes in the specific elements of the allowance for loan losses, including instances in which the overall allowance has not changed significantly. The effects of any changes in methodology should be explained and justified.

.82 *SEC Staff Actions Concerning MD&A.* If statistical data, quantitative analysis, or disclosures in a registrant filing appear inconsistent with loan loss allowance levels, the SEC staff may require the institution to explain those inconsistencies. For example, data commonly used to evaluate the appropriateness of the loan loss allowance may indicate an inconsistency between the accounting for the allowance and the disclosure of material risks in the portfolio for which the allowance was maintained. In such a case, the SEC staff may issue comments on the filing relating to the loan loss allowance.

.83 Additionally, disclosures in the filing should be consistent with the documentation supporting the level of the loan loss allowance. The SEC staff may question allowances that appear too low as well as those that appear too high, as compared with the disclosures made and the supporting documentation.

.84 The SEC letter on the allowance for loan losses issued in January 1999 provides essential information that needs to be considered and included in the "Description of Business," MD&A, and financial statements. (See the SEC Web site at www.sec.gov/rules/other/banklla.txt.) Additionally, the August 2001 SEC current accounting and disclosure letter (section K) provides further loan loss guidance. (See www.sec.gov/divisions/corpfin/acctdisc.html.)

Technology News

Customer Relationship Management

.85 Financial service companies usually spend more on information technology than other businesses, and 2002 is no exception, defying predictions that a weak economy and last year's terrorist attacks would hinder spending in this area. Financial firms spend more than 8 percent of their revenue on technology, among the highest of all industries.

.86 One of the highest areas of technological growth in 2002 has been in the area of customer relationship management (CRM). Demand for CRM software has been high, but results have not been up to expectations. Enticed by the promise of a quick means for personalizing customer services, increasing retention, sharpening cross sales and making customers more profitable, financial institutions have spent millions on CRM initiatives. Some of these initiatives have been worthwhile, but many have failed to deliver on expectations

and have resulted in wasted investment, shelved projects and firings. As a result, the industry is taking a slower and steadier approach to CRM. Success requires that technology be a tool, not a comprehensive solution to CRM.

Check Imaging

.87 A new developing area of customer relationship management is check imaging technology. This technology is meant to solve one of the most vexing customer relationship management issues that financial institutions face, namely, how to supply their customers with timely information about check payments. By successfully producing check images for customers, a financial institution can meet a major goal of CRM; to increase internal growth by improving service and winning more business from existing customers.

.88 Check imaging technology has been around for more than a decade but is only just beginning to live up to its early hype. The idea of capturing check images and storing them in an archive is gaining popularity throughout the industry. Many medium and large size banks are now starting to look seriously into image archiving. Institutions that implement this product will have significant competitive advantage over other players.

.89 The nation's largest check processor, Bank of America, is the first institution to implement the technology, and has begun taking electronic pictures of each of its 800 million monthly checks. The company can now download check images to representatives at bank branches or call centers. In addition, customers can request images through the Internet or automated teller machines (ATMs). Customers are happy since images are available through varied delivery channels. Institutions stand to save billions of dollars in transportation costs by exchanging electronic checking account information for actual paper checks.

The Decline of Internet Banks

.90 Despite industry predictions of market growth, Internet banks have either closed, contracted, explored their strategic options, or sold themselves in large numbers, leaving fewer institutions to carry out the plan of providing cheaper banking services through streamlined or nonexistent branch infrastructures.

.91 Internet banks of all types had trouble this year. Among the Internet banks that are still in existence, only Net Bank and E-Trade Bank stand out as having significant customer and asset bases. Net Bank focused from the start on profitability, not branding. E-Trade bank has both the benefit of longevity through its 1980s predecessor Telebank and a cross sell boost from its brokerage parent, E-Trade Group.

.92 The failure of so many Internet banks may have been due to traditional banks expanding operations onto the Internet. These traditional institutions showed impressive growth in their online banking customers. In short, it appears that consumers want more from a bank than Internet-only portals. They want branches and full service as well.

A New Foreign Exchange Settlement Method

.93 A new service has appeared on the market that settles foreign exchange (fx) trades simultaneously and irrevocably. The service known as *continuous linked settlement*, went live on September 9, 2002, after two postponements. It is run by CLS Bank International, which obtained regulatory approval from the Federal Reserve Bank of New York.

.94 CLS Bank International was formed by a consortium of banks for the purpose of consolidating and mitigating risk in foreign exchange trading. The only way for a bank to send transactions directly through CLS is to invest \$5 million and become a shareholder. CLS Bank does not execute the trades. It simply settles payments for trades. The new fx continuous linked settlement is complementary to the trading platforms that execute trades such as Fxall, Currenex Inc., and Fx connect.

.95 The system settles bank-to-bank foreign exchange settlement transactions within a few hours rather than two days or more. This reduces risks from multiple time zones, settlement delays and legal jurisdictions. The risk of paying in one currency and failing to receive in another is reduced since both sides are settled at once.

.96 This new fx settlement system has the potential to become industry practice, despite the initial expense of becoming a shareholder.

ATMs Versus Western Union

.97 The demand for international person-to-person money transfers is heating up, with strong development from two major banks that think that they can use ATM networks and card products to take money transfer share away from the market leader, Western Union. Two market factors have lead to this development. First, the immigrant market has become a significant revenue opportunity. Over the last five years, the consumer sector in the United States of Mexicans, and Central and South American peoples has grown, spurring market demand for cross-border money transfers. There has also been a significant increase in ATMs and Internet access south of the Rio Grande. Second, there is a rising ATM and Internet use among all population sectors.

.98 It still remains to be seen whether ATM money transfers will take off, especially given obvious security issues, including the potential that the machines could be used for money laundering. But there is room for a new trend of global remitters in the next four or five years, especially through the Internet and ATMs.

Fraud and Illegal Activities

Money Laundering Developments

.99 Criminals use financial institutions to launder the proceeds of crime. Omnibus providers of diversified financial services may be particularly vulnerable because they provide a broad range of financial services that money launderers want and need, often in higher risk jurisdictions.

Definition of Money Laundering

.100 *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 jurisdictions. Current estimates of the size of the global annual “gross money laundering product” range from \$500 billion to \$1.5 trillion.

Money Laundering in the Electronic Age

.101 Recent cases underscore how criminals are increasingly using personal computers, banking software, electronic funds transfers, and the Internet to launder the proceeds of their illicit activities. Large volumes of high-speed wire transfers between institutions on a daily basis make it exceedingly difficult for regulators, law enforcement, and financial institutions to identify money laundering activities.

Inadequate Controls Increase Risk of Money Laundering

.102 Evidence suggests that financial institutions penetrated by money launderers may not have sufficient controls in place for effective money laundering risk management, including adequate processes for identifying unusual activity and determining whether unusual activity is really suspicious and reportable.

.103 In a number of instances, organized crime associates were employed at the affected institutions and existing controls were inadequate for management to detect suspicious or improper relationships and activities involving the criminals.

The USA Patriot Act

.104 On October 26, 2001, President Bush signed into law the “Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001” (the Act). This law, enacted in response to the terrorist attacks of September 11, 2001 was intended to strengthen our nation’s ability to combat terrorism and prevent and detect money laundering activities in all financial institutions. Broad authority to develop anti-money regulations applicable to each of the various segments of the financial services industry was delegated to the Treasury Department.

.105 On July 17, 2002, the Treasury Department, along with the FDIC, FRB, NCUA, OCC, OTS, Commodity Futures Trading Commission, and the SEC issued proposed rules that would require certain financial institutions to establish minimum procedures for identifying and verifying the identity of customers seeking to open new financial accounts. These proposed rules implement section 326 of the USA PATRIOT Act, which directs the issuance of regulations requiring financial institutions to implement reasonable procedures for (1) verifying the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintaining records of the information used to verify the person’s identity and; (3) determining whether the person appears on any list of known or suspected terrorists or terrorist organizations. Final rules implementing section 326 must be effective by October 25, 2002.

.106 Unless exempted by regulation, financial institutions must establish an anti-money-laundering compliance program, including, at a minimum:

- The development of internal policies, procedures, and controls; these should be appropriate for the level of risk of money laundering identified.
- The designation of a compliance officer; the officer should have appropriate training and background to execute their responsibilities. In addition, the compliance officer should have access to senior management.
- An ongoing employee training program; a training program should match training to the employees’ roles in the organization and their job functions. The training program should be provided as often as necessary to address gaps created by movement of employees within the organization and turnover.
- An independent audit function should test procedures.

.107 Additionally, on January 4, 2002, interim guidance was issued to financial institutions on how to comply with two other anti-money-laundering provisions of the Act. Effective December 25, 2001, financial institutions are prohibited from providing correspondent accounts directly to foreign shell banks and are required to take steps to ensure that correspondent accounts are not being used indirectly to provide banking services to such shell banks. A “prohibited” shell bank is one that has no physical presence in a country. This excludes a shell bank that is affiliated with a U.S. or foreign bank that has a physical presence and is regulated. Additionally, financial institutions are required to keep records of the owners of foreign banks to which they provide correspondent accounts and of the foreign banks’ agent designated to accept service of legal process.

Other Related Laws and Regulations

.108 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.

.109 The BSA contains a suspicious activity reporting (SAR) requirement that applies to insured banks, savings associations, savings association service corporations, credit unions, bank holding companies, nonbank subsidiaries of bank holding companies, edge and agreement corporations, and U.S. branches and agencies of foreign banks operating in the United States. These financial institutions 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. In June, 2000, the NCUA, FRB, FDIC, OCC, and OTS issued a newly revised SAR form.

.110 The BSA also contains regulations requiring financial institutions to file currency transaction reports (CTRs) for cash transactions greater than \$10,000.

.111 **BSA Compliance Deficiencies.** Recent examinations by the OCC have revealed some common BSA compliance deficiencies. The OCC found that some institutions failed to adequately:

- Document and evaluate new, high-risk accounts for money laundering.
- Establish controls and review procedures for high-risk services.
- Monitor high-risk accounts for money laundering.
- Conduct adequate, independent testing of high-risk accounts for the possibility of money laundering.
- Train employees to detect suspicious activity in higher risk areas.
- Review CTR filing patterns for suspicious activity.

The OCC reminds financial institutions that they must have adequate internal controls, independent testing, responsible personnel, and training to comply with the BSA.

Federal Government Initiative Looks to CPAs to Fight Money Laundering

.112 The government's National Money Laundering Strategy Report of September 2001 identifies addressing the role of "legal and accounting professionals in combating money laundering" as a priority supporting the objective of increasing usefulness of reported information to law enforcement agencies and the financial industry. (See www.treas.gov.)

Money Laundering and Financial Statements

.113 Money launderers tend to use the business entity more as a conduit than as a means of directly expropriating assets. For this reason, money laundering is far less likely to affect financial statements than other types of fraud such as misappropriations and consequently is unlikely to be detected in a financial statement audit. In addition, other forms of fraudulent activity usually result in the loss or disappearance of assets or revenue, whereas money laundering involves the manipulation of large quantities of illicit proceeds to distance them from their source quickly and without detection. However, money laundering activities may have indirect effects on an entity's financial statements.

.114 Nevertheless, independent auditors have a responsibility under SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), to be aware of the possibility that illegal acts may have occurred, indirectly affecting amounts recorded in an entity's financial statements.

.115 Possible indications of money laundering include the following:

- Transactions that appear inconsistent with a customer's known legitimate business or personal activities or means; unusual deviations from normal account and transaction patterns
- Situations in which it is difficult to confirm a person's identity
- Unauthorized or improperly recorded transactions; inadequate audit trails

- Unconventionally large currency transactions, particularly in exchange for negotiable instruments or for the direct purchase of funds transfer services
- Apparent structuring of currency transactions to avoid regulatory recordkeeping and reporting thresholds (such as transactions in amounts less than \$10,000)
- Businesses seeking investment management services when the source of funds is difficult to pinpoint or appears inconsistent with the customer's means or expected behavior
- Uncharacteristically premature redemption of investment vehicles, particularly with requests to remit proceeds to apparently unrelated third parties
- The purchase of large cash value investments, soon followed by heavy borrowing against them
- Large lump-sum payments from abroad
- Purchases of goods and currency at prices significantly below or above market
- Use of many different firms of auditors and advisers for associated entities and businesses
- Forming companies or trusts that appear to have no reasonable business purpose

.116 Money laundering is considered to be an illegal act with an indirect effect on financial statement amounts. Under SAS No. 54, the auditor should be aware of the possibility that such illegal acts have occurred. If specific information comes to your attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, you should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

.117 You 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.

.118 *Section 10A of the Securities Exchange Act of 1934.* The Private Securities Litigation Reform Act of 1995, among other things, amended the Securities Exchange Act of 1934 to add Section 10A. This section requires that each audit under the Exchange Act include procedures regarding the detection of illegal acts, the identification of related party transactions, and an evaluation of the issuer's ability to continue as a going concern. Section 10A also codified certain then-existing professional auditing standards regarding the detection of illegal acts by issuers and imposed expanded obligations on auditors to report in a timely manner to management any information indicating that an illegal act has or may have occurred. The auditor must ensure that the audit committee or board of directors is adequately informed with respect to an illegal act, as broadly defined by Section 10A, unless the illegal act is clearly inconsequential.

.119 In addition, Section 10A requires the issuer to notify the SEC within one business day after the issuer's board of directors is informed by its auditor that the auditor reasonably expects to resign from the audit engagement or to modify its audit report due to an illegal act that has a material effect on the issuer's financial statements for which appropriate remedial action has not been taken by senior management and the board of directors. If the issuer does not notify the SEC within that period, then the auditor, within the next business day, must provide a copy of the illegal acts report (or documentation of any oral report) that it gave to the board directly to the SEC. Section 10A provides for cease and desist and civil money penalties to be imposed against auditors who willfully fail to provide the required reports.

Financial Crimes Enforcement Network Advisories

.120 The Financial Crimes Enforcement Network (FinCEN) is the policy-making and law enforcement agency within the U.S. Department of the Treasury that supports law enforcement investigative efforts and fosters interagency and global cooperation against domestic and international financial crimes. FinCEN constantly issues advisories about transactions. These advisories normally instruct financial institutions to

give enhanced scrutiny to any transaction originating in or routed through higher risk jurisdictions. Periodically, the federal government reviews and reassesses foreign government and financial system risk, cooperation, and compliance and accordingly adds names to and removes names from the sanction lists. It should be emphasized that the issuance of these advisories does not mean that financial institutions should curtail legitimate business with these jurisdictions.

National Interdiction and Sanction Laws

.121 The Department of the Treasury's Office of Foreign Assets Control (OFAC) administers sanction programs against Libya, Liberia, Iraq, Cuba, North Korea, the National Union for the Total Independence of Angola (UNITA), Sierra Leone, Sudan, Yugoslavia, Burma, the Balkans, Iran, the Taliban in Afghanistan, and generally persons who are classified as specially designated nationals (SDNs), who may include known international terrorists and narcotics traffickers. Financial transactions with these regimes, entities, and individuals may be prohibited or restricted by federal law. Information concerning OFAC rules, lists of prohibited entities, and general OFAC information can be obtained on the OFAC Web site at www.ustreas.gov/ofac.

Advice for Credit Unions

.122 Credit unions have been singled out in the past by the Treasury Department for having the worst compliance record among financial institutions in the area of the administration and enforcement of the Bank Secrecy Act and OFAC requirements. It is likely that compliance and procedures will continue to be closely watched by regulators and law enforcement agencies due to our war against terrorism.

.123 The Bank Secrecy Act of 1970 provides requirements for financial institutions to maintain records regarding member transactions and that they report certain transactions involving currency over \$10,000. The NCUA Rules and Regulations Section 748.2 (1986) provides further specific requirements for credit unions to ensure their compliance with the BSA. *Section 748.2 requires that credit unions have a formal BSA compliance program and adequate training and monitoring procedures.* Management needs to ensure that it has a reasonable BSA compliance program in place to independently test for compliance with the BSA, proper completion of cash transaction reports, proper completion of Suspicious Activity Reports, and identification and prevention of any transactions with OFAC restricted nations, individuals, or organizations.

.124 Fines and sanctions for failure to comply can be enormous. In addition to fines and penalties, criminal sanctions can be imposed against the officers and directors of financial institutions. The credit union should look carefully at its policies and procedures to ensure compliance with the BSA and with the OFAC restrictions.

.125 Credit union management should review this area to ensure compliance with provisions of the BSA and OFAC requirements.

In the Spotlight

Outsourcing to Third-Party Vendors and Services Organizations

.126 Financial institutions are placing much greater reliance on third parties to perform a variety of services including the processing of transactions and information. With a growing list of new products and services, an increasing number of third-party vendors are being utilized by financial institutions. Every day, new key products are developing such as account aggregation, portals, home banking, CRM, MCIF systems, Web hosting, and telephony systems. Also, many banks and credit unions today are relying on outside vendors to perform many functions that were previously done in-house because of labor shortages, cost savings, increased complexities, and a host of other reasons.

.127 Increases in both the number and complexity of outside services have created new emerging risks. There is an exposure that basic due diligence such as contract reviews and background checks will not be adequately completed as it becomes more difficult to manage a vast number of vendors. Additional risks are also emerging with the increase in technology-related vendors. Reliance on technology-related vendors causes additional risks due to factors such as increased complexities, access to member account information, and reliance by the institution for processing of transactions. The risks are further compounded if the services provided involve the use of the Internet and other technologies because of the potential for individuals outside of the vendor or financial institution to access information and potentially perform unauthorized transactions. A number of financial institutions have incurred substantial losses due to fraud or failures at outside service organizations on which the financial institution had placed reliance.

.128 The regulatory agencies have recognized these increased risks and have issued guidance on reasonable procedures that should be put into place to properly manage these risks. In November 2001, the OCC issued OCC Bulletin 2001-47 providing guidance to national banks on managing the risks that may arise from their business relationships with third parties. Additionally, the NCUA issued letter 01-CU-20 in November 2001 entitled "Due Diligence Over Third Party Service Providers." The OCC provides guidance on critical aspects of a risk management and due diligence process covering third-party providers. The risk management process should include:

- A risk assessment to identify the bank's needs and requirements
- Proper due diligence to identify and select a third-party provider
- Written contracts that outline duties, obligations, and responsibilities of the parties involved
- Ongoing oversight of the third parties and third-party activities

The bulletin can be obtained at www.occ.treas.gov.

.129 The NCUA in letter 01-CU-20 provides direction that credit union officials should follow to perform the necessary due diligence. Minimum procedures that must be followed include planning, at which time the officials need to determine, among other things, whether the proposed activities are consistent with the financial institution's overall business strategy and risk tolerances. Other procedures that must be followed include background checks, legal and financial review, return on investment, and insurance requirements.

Due Diligence

.130 The extreme end of the potential vendor risk exposure involves addressing unscrupulous or unsound vendors who could cause losses to the financial institution and its stakeholders. There have been instances in which institutions have suffered substantial losses from unscrupulous or unsound vendors such as investment brokers, leasing companies, insurance companies, and a host of others. It is absolutely critical that the institution perform reasonable due diligence on the integrity and financial strength of all critical vendors on an ongoing basis, especially if the vendor has access to, controls, or is responsible for large dollar amounts of the financial institution's assets. If the vendor processes information and transactions or otherwise has access to member information, the institution also needs to ascertain that the vendor has reasonable internal controls in place and is adequately bonded.

Some Auditing Considerations

.131 An auditor should obtain an understanding of each of the five components of an institution's internal control sufficient to plan the audit. This understanding may encompass controls placed in operation by the financial institution and by services organizations whose services are part of the institution's information system. SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, and SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), provide relevant auditing guidance. Note that many vendors have

not had SAS No. 70 reports prepared, or if they have been prepared, a significant fee is charged to obtain a copy. The auditor may need to communicate the importance of SAS No. 70 reports to the client and that there may be additional cost involved in obtaining the report.

.132 The Auditing Standards Board (ASB) has issued a new Audit Guide entitled *Service Organizations: Applying SAS No. 70, as Amended*. The Guide includes illustrative control objectives as well as three new Interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information, subsequent events, and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

.133 Procedures need to be in place to ensure that expanding relationships are well controlled. The security of information, privacy of members, and assurance that you are dealing with an ongoing solid entity is extremely important. Management should have a vendor risk management program in place. The risk management program needs to raise questions concerning vendor relationships such as:

- Was an initial due diligence review completed?
- Is there an ongoing due diligence review and vendor oversight?
- Where do each of the parties' rights, responsibilities, and liabilities lie with existing vendor contracts?
- Do contracts adequately protect the institution's legal interests, and has counsel reviewed them?
- How does the institution ensure the vendor provides adequate services to customers/members and employees?

Regulator Working Paper Reviews

.134 If you are a CPA who audits financial institutions, sooner or later federal and state bank regulators will ask to see a copy of your audit working papers. CPAs who frequently perform bank audits say they can help examiners accomplish more, with fewer headaches for themselves, if they work with the examiners to make working paper reviews efficient.

Who Has the Power?

.135 Depending upon which agency is making the request and how big the financial institution is, the regulatory agency may have specific regulatory authority to demand the working papers. Under the Federal Deposit Insurance Corporation Improvement Act of 1991, auditors are required to make working papers available upon request to regulators for client banks with assets in excess of \$500 million. If the agency does not have the authority, it always can subpoena the documents. In addition, the Interagency Policy Statement on External Auditing Programs of Banks and Savings Institutions provides guidance to depository institutions in establishing an effective external audit program. The policy statement specifically requires explicit language in the engagement letter granting examiners access to the auditor's working papers. The interagency policy became effective on January 1, 2000. In addition, many *financial institutions, at regulators' urging, have recently reworded their audit engagement letters to require that the working papers be made available.*

.136 Guidance for providing regulators with access to auditors' working papers can be found in "Working Papers: Auditing Interpretations of Section 339A" (AICPA, *Professional Standards*, vol. 1, AU sec. 9339A). Additionally, SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339A), among other things, supersedes SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339A), and is effective for audits of financial statements for periods beginning on or after May 15, 2002. Early application is permitted. If SAS No. 96 has not been adopted, auditors should refer to SAS No. 41 for guidance.

.137 Additionally, the FDIC has released guidance instructing FDIC examiners to review a bank's external auditors' working papers in cases where the bank has a CAMEL rating of 4 or 5, or when the examiner has significant concerns with bank operations that may have been tested by the external auditor. For all examinations, FDIC examiners are also instructed to obtain from the institution and review all correspondence between the institution and external auditor, with a focus on material weaknesses and reportable condition communications. The FDIC notice states that examiners can sign a letter from the auditor acknowledging receipt of the auditor's letter specifying terms of the working paper review; however, examiners may not sign any document that implies that the FDIC has agreed to any conditions in the letter.

.138 To obtain a copy of the memorandum (RD Memorandum Transmittal 2000-019, Review of External Auditors' Workpapers), contact the FDIC's Public Information Center: call (800) 276-6003 or (202) 416-6940; fax (202) 416-2076; or e-mail publicinfo@fdic.gov.

The Paper Chase

.139 Note that meeting a request for working papers does not mean dumping loads of paper into the laps of bank examiners. When examiners ask to look at working papers, the CPA should talk to them first, find out what they are trying to do, and determine what they are looking for. You may be able to satisfy the examiner's needs by talking. If not, then direct them to working papers that will help them answer their questions. Note that the purpose of a working paper review is examination scoping, in which a review of the work can help regulators better focus their own resources. Additionally, examiners are concerned about the possible existence of client fraud and regulators want to know what the auditors have done to detect it and to what extent internal controls have been examined. Additionally, the working paper review should assess whether the financial institution was meeting statutory and regulatory requirements, and whether its board had implemented and was effectively overseeing an appropriate external audit program.

.140 Look for changes in regulatory oversight over the next year due to new legislation, including the Sarbanes-Oxley Act of 2002. Additionally, the AICPA has issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). This SAS supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU secs. 110, 230, 312, and 316A), and amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230). SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 31, 2002. Early application is permitted. See the "New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance" section of this Alert for a discussion of SAS No. 99.

.141 Note that federal regulators may be investigated by the Congress as far as their oversight role for banks involved with WorldCom and Enron. Therefore, it is feasible that the regulators may put more demands on auditors during their year-end working paper reviews in anticipation of being reviewed themselves.

.142 Ever since regulators began filing lawsuits against accounting firms during the savings and loan crisis of the 1980s, CPAs worry about just whom federal regulators are concerned with when they look at working papers—banks or their accounting firms? This leads to wariness on the part of CPAs during communications. Note that regulators that oversee the nation's financial institutions reserve the right to report any serious audit deficiencies to the institutions they examine. If deficiencies are severe enough, regulators can suggest a change in auditors.

.143 However, the OCC recently released guidance clarifying issues concerning its supervision of national banks' audit programs, including reviews of external audit programs, key independence issues affecting outsourced internal audit activities, and responsibilities of audit committees. The guidance states that an OCC review of a bank's external audit program is not intended to be an "audit of the auditors." Rather, it is an assessment of whether statutory and regulatory requirements for external audits and audit

committees are met, whether the bank's board has implemented an appropriate external audit program, and whether a bank's board effectively oversees the external audit program. To obtain a copy of the memorandum (MM 2001-1, Audit Policy Clarification), contact the OCC's Public Information Room by calling (202) 874-5043 or faxing (202) 874-4448.

.144 Working paper review can play an appropriate role in bank supervision today. Accountants can help regulators be more efficient during their reviews so they do not have to reperform work that internal and external auditors have performed to their satisfaction. Also, working paper review helps regulators get their arms around a new client to obtain better understanding of a newly regulated institution.

Mortgage Loan Servicing and Secondary Market Sales

.145 Some financial institutions have been significantly increasing their real estate loan portfolios, as well as enhancing their servicing portfolios of loans sold in the secondary market with servicing retained by the institution. Institutions in recent years have been much more likely than in the past to retain servicing for loans sold to secondary market investors. Not only has the number of financial institutions that are servicing portfolios grown considerably, but the size and dollar amount of institutions' servicing has also grown substantially. Conversely, the recent refinancing boom has adversely affected certain institutions, as borrowers have moved to other institutions in a highly competitive market.

.146 The value of associated mortgage-servicing rights (MSRs) is an important emerging material area for auditors and may have a significant effect on your client's financial statements this year or in the near future.

Audit and Accounting Guidance

.147 FASB No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, the AICPA audit and Accounting Guides *Banks and Savings Institutions*, and *Audit of Credit Unions*, and SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, provide guidance related to mortgage loan servicing.

.148 The FASB published a Special Report on February 15, 2001, that addresses the most frequently asked questions about FASB Statement No. 140. On April 19, 2001, the FASB staff published a set of questions and answers about isolation of financial assets transferred by banks and other entities, focusing on rights of redemption. Finally, on August 7, 2001, the FASB staff published a set of questions and answers about the limitations on the activities of a qualifying special-purpose entity set forth in paragraphs 35 through 44 of FASB Statement No. 140.

.149 For those institutions that have mortgage servicing operations, the auditor should evaluate whether the institution is complying with the relevant accounting requirements. The auditor should gain assurance that the financial institution is properly recording the asset (or liability), and gain or loss on sale when loans are sold with servicing retained. Assurances should also be made that the institution is properly amortizing the MSRs and that procedures are in place to properly assess fair value for potential impairment.

.150 Additionally, the various mortgage-related entities such as the Department of Housing and Urban Development (HUD), Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC, also known as Freddie Mac), and Government National Mortgage Association (GNMA, also known as Ginnie Mae) have various audit and reporting requirements.

.151 Another consideration is further activity related to the sales of such loans. As the income is recorded up-front at the sale date and the MSRs are amortized to expense in proportion to net servicing income, if the current level of sales activity is not sustained, the institution will be affected by the loss of such sales income.

.152 Apart from the proper accounting treatment for loans sold and accounting for retained servicing, the auditor may also want to evaluate the internal control of the servicing operations. The financial institution will have numerous financial and compliance obligations and responsibilities, such as collecting and remitting loan payments, ensuring compliance with federal and state regulations covering escrow accounts and other servicing requirements; compliance with the seller servicing agreement with a third party such as Fannie Mae and Freddie Mac; properly collecting on delinquent accounts; and collecting and paying taxes and insurance. Failure to properly comply with any of these requirements could have serious financial impact on the financial institution.

Recent Regulatory Actions at a Glance

.153 The financial institution industry in general is subject to various monetary and fiscal policies and regulations, which include but are not limited to those determined by the FRB, the OCC, the FDIC, state regulators, the OTS and the NCUA.

.154 This section presents some important recent regulatory actions. The list of regulatory actions is not comprehensive and the information provided represents only summaries of the regulations. Readers should visit the Web sites of the various regulatory agencies for complete listings of new regulations and for full descriptions of the regulations. Regulatory Web sites are:

- FDIC: www.fdic.gov
- FFIEC: www.ffiec.gov
- FRB: www.federalreserve.gov
- NCUA: www.ncua.gov
- OCC: www.occ.treas.gov
- OTS: www.ots.treas.gov
- SEC: www.sec.gov

Interagency Guidance

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- On November 29, 2001, the FRB, FDIC, OCC and OTS published final rules that changed regulatory capital standards to address the treatment of recourse obligations and direct credit substitutes that expose banking organizations to credit risk. The rule also added new capital standards for residual interests. The revised rule primarily affects institutions involved in securitization activities, and it is intended to result in more consistent risk-based capital treatment of these transactions among the four agencies. (12 CFR 325) www.fdic.gov
- On January 25, 2002, the FRB, FDIC, and the OCC published final rules governing the regulatory capital treatment of equity investments in nonfinancial companies held by banks, bank holding companies and financial holding companies. The final rules are effective April 1, 2002. (www.federalreserve.gov)
- On March 19, 2002, the FRB, FDIC, OCC, OTS, and the NCUA announced that financial institutions they supervise should follow the guidance issued by the SEC with respect to auditing and accounting work performed under Arthur Andersen LLP. The SEC announced on March 14 and 18 that it would continue to accept financial statements audited by Andersen provided the companies filing the statements obtain from Andersen certain representations concerning audit quality and controls and generally set forth those representations in their filings. The SEC's statements are available on its Web site at www.sec.gov.

- On April 9, 2002, the FRB, FDIC, OCC, and the OTS published a final rule amending their risk-based capital standards for banks, bank holding companies, and savings associations (institutions) to reduce the risk weight applied to claims on, or guaranteed by qualifying securities firms. The rule is effective July 1, 2002. (www.federalreserve.gov)
- On May 17, 2002, the FRB, FDIC, OCC, and OTS issued an interagency advisory on the regulatory capital treatment of accrued interest receivable related to credit card securitizations. This advisory describes how this asset is created, explains why it is considered a subordinated retained interest for regulatory capital purposes, and describes the regulatory capital treatment that institutions should apply to this asset no later than December 31, 2002. (www.fdic.gov)
- On May 23, 2002, the FRB, FDIC, OCC, and OTS issued interagency guidance on implicit recourse in asset securitizations. The issuance describes the agencies' concerns with implicit recourse, which exists when an institution supports a securitization above and beyond its contractual obligations, and the supervisory actions that may be taken against an institution that provides implicit support to its securitizations. It also includes examples of post-sale support that institutions have provided to securitizations and discusses whether they constitute implicit recourse. (www.fdic.gov)
- On May 23, 2002, the FRB, FDIC, OCC, and OTS issued an interagency advisory on the unsafe and unsound use of covenants tied to supervisory actions in securitization documents. This advisory describes covenants that use certain supervisory actions as triggers for early amortization events or the transfer of servicing in securitizations and explains that the presence of such covenants in securitization documents will be criticized as an unsafe and unsound banking practice. (www.fdic.gov)
- On May 24, 2002, the FRB, FDIC, OCC, and OTS released interagency questions and answers on the capital treatment of recourse, direct credit substitutes, and residual interests in asset securitizations. This document addresses several implementation questions that had been raised concerning the agencies' final regulatory capital rules issued on November 29, 2001, which were described above. (www.fdic.gov)
- On June 5, 2002, the FRB, FDIC, and the OCC issued final regulations amending their rules that currently prohibit interstate branches from being used primarily for deposit production. The Riegle-Neal Interstate Banking and Branching Efficiency Act prohibits any bank from establishing or acquiring a branch outside of its home state primarily for the purpose of deposit production. Section 101 of the Gramm-Leach-Bliley Act expands this prohibition to include any branch of a bank controlled by an out-of-state bank holding company. To conform their regulations to this statutory change, the agencies have amended their rules so that the prohibition against deposit production office also applies to any bank or branch of a bank controlled by an out-of-state holding company. The regulations are effective October 1, 2002. (www.federalreserve.gov)
- On June 24, 2002, the FRB, FDIC, and the OCC issued the host state loan-to-deposit ratios that the banking agencies will use to determine compliance with section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. These ratios update data released in June 2001. (www.fdic.gov)
- On July 17, 2002, the Treasury Department along with the FDIC, FRB, NCUA, OCC, OTS, Commodity Futures Trading Commission, and the SEC issued proposed rules that would require certain financial institutions to establish minimum procedures for identifying and verifying the identity of customers seeking to open new financial accounts. These proposed rules implement section 326 of the USA PATRIOT Act, which directs the issuance of regulations requiring financial institutions to implement reasonable procedures for (1) verifying the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintaining records of the information used to verify the person's identity and; (3) determining whether the person appears on any list of known or suspected terrorists or terrorist organizations. Final rules implementing section 326 must be effective by October 25, 2002.

Federal Deposit Insurance Corporation

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- On October 30, 2001, the FDIC published a final rule clarifying the meaning of the statutory requirement that an institution must be “engaged in the business of receiving deposits other than trust funds” in order to be eligible for FDIC insurance. Under the amended regulations, an institution can satisfy this standard by maintaining one or more non-trust deposit accounts that, in the aggregate, total \$500,000 or more. (12 CFR 303) (www.fdic.gov)
- On April 25, 2002, the FDIC issued guidance to banks regarding Securities Investor Protection Corporation coverage for banks that use securities broker-dealers for the safekeeping of securities. The guidance reminds banks of the credit risks associated with these custodial relationships. It advises banks to review existing custodial relationships, evaluate the creditworthiness and reputation of custodians, and ensure that the bank maintains properly diversified custodial relationships.

Federal Financial Institutions Examination Council

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- On July 22, 2002, the FFIEC issued draft interagency guidance on account management and loss allowance guidance for credit card lending. The guidance will apply to all institutions under the agencies’ supervision that offer credit card programs. It describes the agencies’ expectations for prudent risk management practices for credit card activities, particularly with regard to credit line management, over-limit accounts, and workouts. The draft guidance also addresses income recognition and loss allowance practices for credit card lending. (www.ffiec.gov)
- On August 8, 2001, the FFIEC released guidance on the risks and risk management controls necessary to authenticate the identity of customers accessing electronic financial services. This guidance, *Authentication in an Electronic Banking Environment*, addresses the verification of new customers and the authentication of existing customer. It applies to both retail and commercial customers. (www.ffiec.gov)

Federal Reserve Board

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- On December 12, 2001, the FRB approved a final rule that amends its regulations aimed at curbing predatory lending. Compliance with the amendments becomes mandatory on October 1, 2002. The amendments to regulation Z (Truth in Lending) broadens the scope of loans subject to the protections of the Home Ownership and Equity Protection Act of 1994 by adjusting price triggers that determine coverage under the act. (www.federalreserve.gov)
- On January 23, 2002, the FRB published revisions to its Regulation C (Home Mortgages Disclosure). The amendments establish the thresholds for determining the loans for which financial institutions must report loan-pricing data (the spread between the annual percentage rate on a loan and the yield on comparable Treasury securities). It also requires lenders to report the lien status of applications and originated loans. Compliance with the amendments relating to the thresholds and lien status is mandatory on January 1, 2004. The amendments also require that lenders ask applicants their ethnicity, race, and sex in applications taken by telephone. The data collection requirement effective date is January 1, 2003. (www.federalreserve.gov)
- On August 15, 2002, the FRB made significant revisions to Regulation C (12 CFR 203), the implementing regulation for the Home Mortgage Disclosure Act, 12 USC 2801 et seq. (HMDA). Most of the changes become effective January 1, 2004, for data required to be reported by March 1, 2005. However, two changes become effective January 1, 2003, for data due by March 1, 2004. See the FRB web site for further information.

National Credit Union Administration

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- In November, 2001, the NCUA issued letter 01-CU-20 entitled “Due Diligence Over Third Party Service Providers,” which provides guidance on critical aspects of a risk management and due diligence process covering third party providers. (www.ncua.gov)
- On May 28, 2002, the NCUA issued Interpretive Ruling and Policy Statement (IPRS) 02-3 on the ALLL. It provides guidance on the design and implementation of ALLL methodologies and is similar to interagency policy statements of the federal banking agencies published on July 6, 2001, and similar federal banking guidance issued by the SEC in Staff Accounting Bulletin No. 102. The IRPS does not change the existing accounting guidance and does not address or change current guidance with loan chargeoffs. For additional information, see the description under “Credit Risk Watch” section of this Alert. (www.ncua.gov)

Office of the Comptroller of the Currency

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- In November 2001, the OCC issued OCC Bulletin 2001-47 providing guidance to national banks on managing the risks that may arise from their business relationships with third parties. (www.occ.treas.gov)
- On January 4, 2002, interim guidance was issued to financial institutions on how to comply with two anti-money-laundering provisions of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001.

Effective December 25, 2001, financial institutions are prohibited from providing correspondent accounts directly to foreign shell banks and are required to take steps to ensure that correspondent accounts are not being used indirectly to provide banking services to such shell banks. In addition, financial institutions are required to keep records of the owners of foreign banks to which they provide correspondent accounts and of the foreign banks’ agent designated to accept service of legal process.

It is the expectation of the Department of the Treasury that financial institutions will accord priority to meeting their compliance obligations in connection with foreign banks for which they maintain correspondent deposit accounts. However, the requirements also apply to nondeposit relationships with foreign banks. The interim guidance will remain in effect until superseded by regulation or subsequent guidance. A link to the interim guidance can be found in the U.S. Department of Treasury’s Web site, www.treas.gov/press/.

- On January 31, 2002, the OCC issued a final rule on the regulatory capital treatment of nonfinancial equity investments that was published in the *Federal Register* on January 25, 2002. The final rule is substantially similar to the proposal that the OCC published in February 2001 (66 FR 10212, February 14, 2001). Similar to the earlier proposal, this final rule requires a series of marginal capital charges on equity investments that increase with the level of those investments relative to the bank’s Tier 1 capital. One modification to the proposal is the inclusion of a grandfathering provision. Individual investments are exempt from the revised capital requirements if they were made prior to March 13, 2000. (www.occ.treas.gov)
- On May 28, 2002, the OCC issued a final rule governing national banks’ ability to conduct business using electronic technologies. The regulation was published in the *Federal Register* on May 17 and, except for one provision, is effective on June 17, 2002. The exception is a provision containing certain disclosure requirements for national banks that have co-branded Web sites or other shared electronic space. That provision takes effect on July 1, 2002. (www.occ.treas.gov)

- On August 12, 2002, the OCC amended OCC regulations regarding the capital equivalency deposits (CEDs) that foreign banks with federal branches or agencies must establish and maintain. The rule revises certain requirements regarding CED deposit arrangements to increase flexibility for and reduce the burden on certain federal branches and agencies, based on a supervisory assessment of the risks presented by the particular institution. (www.occ.treas.gov)
- On August 29, 2002, the OCC issued a new handbook for examiners on personal fiduciary services. The handbook addresses a broad range of fiduciary services that banks provide to individuals, their families, and their businesses. Banks provide these services as trustee, investment adviser, or in any capacity in which the bank possesses investment discretion on behalf of another. The handbook is structured by risk framework, outlining the transaction, compliance, reputation, and strategic risk that exists with fiduciary services. (www.occ.treas.gov)
- On September 19, 2002, the OCC published a final rule that adds a new part 37 to the OCC's rulebook that governs debt cancellation contracts and debt suspension agreements. The purpose is to establish standards governing these products in order to ensure that national banks provide such products consistent with safe and sound banking practices and subject to appropriate consumer protections. The effective date is June 16, 2003. (www.occ.treas.gov)

Office of Thrift Supervision

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- On November 1, 2001, the OTS issued Regulatory Bulletin 32-19, which provides an update to Thrift Activities Regulatory Handbook Section 110 Capital Stock and Ownership. This section provides additional guidance for mutual organizations, capital stock, and contributed capital. More specifically, it adds a new section on ownership of mutual associations, revises information on mutual holding companies to reflect the changes introduced by the Gramm-Leach-Bliley Act, and clarifies that savings associations may accept certain capital contributions without limit. (www.ots.treas.gov)
- On February 7, 2002, the OTS issued CEO Memo #156, Certain Transfers of "Higher-Risk" Assets. This memo discusses transfers of high-risk assets including non-performing loans to entities or parties outside of the savings association. The specific transactions addressed are those in which the transferor both (1) retains significant credit risk in the transferred assets, and (2) unlike typical securitization transactions, often provides substantial funding to the transferee. These transfers may be motivated by favorable regulatory reporting treatment but lack economic substance or a sound business purpose and raise supervisory concerns. When such transfers have been made or are being contemplated, the Regional office of OTS should be contacted. (www.ots.treas.gov)
- On February 13, 2002, the OTS issued RB 32-23, which updated the Thrift Activities Handbook. These changes included the highlighting that no less than a majority of outside directors must make up an audit committee and added information on examiner access to external audit working papers. (www.ots.treas.gov)
- On May 22, 2002, OTS issued Transmittal TR-281, which made changes to its capital regulations regarding qualifying mortgage loans, interest-rate risk component and other capital components. These changes are designed to eliminate unnecessary capital burden and to align OTS capital regulations more closely to those of the other federal banking agencies.
- On July 26, 2002, the OTS updated Thrift Activities Handbook Section 350 External Audit and expanded the work of examiners during a review of external audit workpapers. (www.ots.treas.gov)
- On July 31, 2002, OTS issued Regulatory Bulletin RB 32-26 and rescinded RB 32-16. RB 32-26 updates the Thrift Activities Handbook Section 250. OTS significantly revised Appendix A, Bank Owned Life Insurance (BOLI). (www.ots.treas.gov)

The changes include the following:

- Revised the appendix to more closely track the OCC bulletin on BOLI, BC-2000-23
- Stated explicitly that purchasing BOLI that is not incidental to banking is not permitted
- Revised the concentration guidance to make it clear that savings associations' investment in BOLI should not exceed 25 percent of capital
- Added guidance on separate account BOLI
- Made a statement that the lending limit rule can apply to the underlying assets in separate account BOLI provided that certain controls are in place with the insurer
- Added a discussion about insurable interest and stated that holding insurance in excess of the institution's risk of loss is considered unsafe and unsound (www.ots.treas.gov)
- On August 9, 2002, the OTS issued Transmittal TR-290, which amended its regulations on the mutual-to-stock conversion process and portions of its regulations on mutual holding company reorganizations. This rule includes modifications to the provisions addressing business plans. In addition, it addresses certain matters involving conversions from the mutual to the stock form, by, among other things, adding demand account holders to the definition of savings account holders, allowing accelerated vesting in management benefit plans for changes of control, adding rules to establish charitable organizations, and clarifying the policy on the amount of proceeds allowed to be retained at the holding company level. (www.ots.treas.gov)

Securities and Exchange Commission

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- On December 21, 2002, the SEC adopted a rule that states that employee option plans that have not gotten shareholder approval must be disclosed in annual reports and proxy statements. Until now, companies generally have been required to disclose the total number of options awarded. The company must file copies of the equity compensation plans with the SEC unless immaterial. See rule at www.sec.gov for effective date information.
- On March 18, 2002, the SEC adopted rules stating requirements for Arthur Andersen LLP Auditing Clients. The rules assure a continuing and orderly flow of information to investors and markets and minimize any potential disruptions that occurred as a result of the indictment of Arthur Andersen LLP. Effective Dates include March 18, 2002. See rule at www.sec.gov for other dates.
- On August 29, 2002, the SEC adopted final rules for Certification of Disclosure in Companies' Quarterly and Annual Reports. In response to Section 3029(a) of the Sarbanes-Oxley Act of 2002, CEOs and CFOs are now required to certify the financial and other information contained in quarterly and annual reports. Effective Date August 29, 2002. (www.sec.gov)

An Added Note

.163 The AICPA has developed a practice guide to assist members in observing regulatory FTC and SEC privacy and disclosure requirements established by the Gramm-Leach-Bliley Act. (www.aicpa.org/public/download/news)

New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance

.164 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the CPA

Letter, Journal of Accountancy, and the quarterly electronic newsletter, In Our Opinion, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 95	<i>Generally Accepted Auditing Standards</i>
SAS No. 96	<i>Audit Documentation</i>
SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i>
SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>
SSAE No. 11	<i>Attest Documentation</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i>
SQCS No. 6	<i>Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>
Audit Guide	<i>Service Organizations: Applying SAS No. 70, As Amended</i>
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i>
Audit Interpretation No. 1 of SAS No. 73	<i>"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. 140"</i>
Audit Interpretation No. 4 of SAS No. 70	<i>"Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls"</i>
Audit Interpretation No. 5 of SAS No. 70	<i>"Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods"</i>
Audit Interpretation No. 6 of SAS No. 70	<i>"Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor's Engagement"</i>
Audit Interpretation No. 14 of SAS No. 58	<i>"Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing"</i>
Audit Interpretation No. 12 of SAS No. 1	<i>"The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Changes in the Year of Adoption"</i>
Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Practice Alert 02-1	<i>Communications With the Securities and Exchange Commission</i>
Practice Alert 02-2	<i>Use of Specialists</i>
Practice Alert 02-3	<i>Reauditing Financial Statements</i>
Practice Aid	<i>Fraud Detection in a GAAS Audit—An Auditor's Field Guide</i>
Practice Aid	<i>New Standards, New Services: Implementing the Attestation Standards</i>
Practice Aid	<i>Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users</i>

.165 Of the pronouncements and other guidance listed in the previous table, those having particular significance to the financial institution industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*

.166 SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316) and amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230). The Statement does not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02).¹ However, SAS No. 99, establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS).²

.167 The following is an overview of the content of the SAS No. 99:

- *Description and characteristics of fraud.* This section describes fraud and its characteristics. (See paragraphs 5 through 12.)
- *The importance of exercising professional skepticism.* This section discusses the need for auditors to exercise professional skepticism when considering the possibility that a material misstatement due to fraud could be present. (See paragraph 13.)
- *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.* This section requires, as part of planning the audit, that there be a discussion among the audit team members to consider how and where the entity's financial statements might be susceptible to material misstatement due to fraud and to reinforce the importance of adopting an appropriate mindset of professional skepticism. (See paragraphs 14 through 18.)
- *Obtaining the information needed to identify risks of material misstatement due to fraud.* This section requires the auditor to gather the information necessary to identify risks of material misstatement due to fraud, by:
 - a. Inquiries of management and others within the entity about the risks of fraud. (See paragraphs 20 through 27.)
 - b. Considering the results of the analytical procedures performed in planning the audit. (See paragraphs 28 through 30.)
 - c. Considering fraud risk factors. (See paragraphs 31 through 33, and Appendix A, "Examples of Fraud Risk Factors.")
 - d. Considering certain other information. (See paragraph 34.)

¹ 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). 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 (see SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), or fraud.

² Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statement in accordance with generally accepted auditing standards (GAAS). SSAE No. 10, chapter 1, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 101), and Statement on Standards for Consulting Services (AICPA, *Professional Standards*, vol. 2, CS sec. 100) provide guidance to accountants relating to the performance of such services.

- *Identifying risks that may result in a material misstatement due to fraud.* This section requires the auditor to use the information gathered to identify risks that may result in a material misstatement due to fraud. (See paragraphs 35 through 42.)
- *Assessing the identified risks after taking into account an evaluation of the entity's programs and controls.* This section requires the auditor to evaluate the entity's programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation. (See paragraphs 43 through 45.)
- *Responding to the results of the assessment.* This section emphasizes that the auditor's response to the risk of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence. (See paragraph 46.) The section requires the auditor to respond to the results of the risk assessment in three ways:
 - a. A response that has an overall effect on how the audit is conducted, that is, a response involving more general considerations apart from the specific procedures otherwise planned (See paragraph 50.)
 - b. A response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed (See paragraphs 51 through 56.)
 - c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls (See paragraphs 57 through 67.)
- *Evaluating audit evidence.* This section requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the assessment. (See paragraphs 68 through 74.) It also requires the auditor to consider whether identified misstatements may be indicative of fraud and, if so, directs the auditor to evaluate their implications. (See paragraphs 75 through 78.)
- *Communicating about fraud to management, the audit committee, and others.* This section provides guidance regarding the auditor's communications about fraud to management, the audit committee, and others. (See paragraphs 79 through 82.)
- *Documenting the auditor's consideration of fraud.* This section describes related documentation requirements. (See paragraph 83.)

.168 SAS No. 99 includes in Exhibit 1, *Anti-Fraud Programs and Controls*, which has been developed to assist auditors in obtaining an understanding of programs and controls established by management to mitigate specific risks of fraud, or that otherwise help to prevent, deter, and detect fraud. It also includes an amendment to SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333.06 and .16), since SAS No. 99 requires the auditor to make inquiries of management about fraud and risk of fraud. In support of and consistent with these inquiries, the amendment revises the guidance for management representations about fraud currently found in SAS No. 85, paragraph 6h and Appendix A. SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 31, 2002. Early application of the provisions of SAS No. 99 is permissible.

.169 The AICPA will publish in December 2002, a Fraud Practice Aid entitled *Fraud Detection in a GAAS Audit—An Auditor's Field Guide*. See the description of the new Practice Aid in this section for further information.

Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*

.170 The Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772kk) provides guidance to service auditors engaged to issue reports on a service organization's controls that may

be part of a user organization's information system in the context of an audit of financial statements. It also provides guidance to user auditors engaged to audit the financial statements of entities that use service organizations. Guidance on performing service auditors' engagements and using service auditors' reports in audits of financial statements is provided in SAS No. 70, *Service Organizations*.

Practice Aid, *Fraud Detection in a GAAS Audit—An Auditor's Field Guide*

.171 In connection with the issuance of SAS No. 99, the AICPA will issue in December of 2002, a practice aid to help practitioners implement the new fraud guidance. The practice aid is entitled *Fraud Detection in a GAAS Audit—An Auditor's Field Guide* (product no. 006613). The practice aid includes topics such as:

- How the new SAS changes audit practice
- Characteristics of fraud
- Understanding the new fraud SAS
- Best practices
- Practice aids such as:
 - Specialized industry fraud risk factors
 - Common frauds and extended audit procedures

The Practice Aid represents valuable guidance in helping practitioners understand and implement SAS No. 99.

New Accounting Pronouncements and Other Guidance

.172 Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated with Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions</i>
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i> See the "New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance" section above for more information.
SOP 01-5	<i>Amendment to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</i>
SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i>
Technical Practice Aids	<i>Software Revenue Recognition</i>
Questions & Answers	<i>FASB Statement No. 87, Employers' Accounting for Pensions</i>

.173 Of the pronouncements and other guidance listed in the previous table, those having particular significance to the financial institution industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org.

FASB Statement No. 147, *Acquisitions of Certain Financial Institutions*

.174 FASB Statement No. 147, *Acquisitions of Certain Financial Institutions*, addresses guidance on accounting for the acquisition of a financial institution and applies to all acquisitions except those between two or more mutual enterprises (the combination of which is currently being discussed as a separate board topic this year.) FASB Statement No. 147 requires that the excess of fair value of liabilities assumed over the fair value of tangible and identifiable intangible assets acquired in a business combination represents goodwill that should be accounted for under FASB Statement No. 142, *Goodwill and Other Intangible Assets*. Thus, the specialized accounting guidance in paragraph 5 of FASB Statement No. 72, *Accounting for Certain Acquisitions of Banking or Thrift Institutions*, will not apply after September 30, 2002. If certain criteria in Statement No. 147 are met, the amount of the unidentifiable intangible asset will be reclassified to goodwill upon adoption of the Statement. Financial institutions meeting conditions outlined in FASB Statement No. 147 will be required to restate previously issued financial statements. Additionally, the scope of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, has been amended to include long-term customer-relationship intangible assets such as depositor- and borrower-relationship intangible assets and credit cardholder intangible assets.

SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*

.175 SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, applies to any entity that lends to or finances the activities of others. For example, that arrangement may be a secured mortgage loan, an unsecured commercial loan or a financing arrangement that only involves extending credit to trade customers resulting in trade receivables. Those financing activities of all entities are included in the scope of this SOP. The SOP provides specific guidance for other kinds of transactions, such as securities purchases, for certain financial institutions listed in the scope paragraphs of the SOP. To the extent an entity is not considered such a financial institution, as described in those paragraphs, the other guidance provided is not applicable. In other words, only the guidance in this SOP related to the financial and lending activities is applicable for entities not considered to be financial institutions.

.176 SOP 01-6 reconciles and conforms, as appropriate, the accounting and financial reporting provisions established by the AICPA Audit and Accounting Guides, *Banks and Savings Institutions*, *Audits of Credit Unions*, and *Audits of Finance Companies*. The SOP also explicitly incorporates mortgage companies, corporate credit unions, and certain activities of insurance companies in its scope. This SOP will be incorporated in a new AICPA Audit and Accounting Guide, which will supersede the three aforementioned Guides. The new Guide is expected to be issued during the second quarter of 2003. See the SOP for effective date and transition information.

On the Horizon

.177 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that may be relevant to your financial institution engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.178 The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed below. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body**Web Site**

AICPA Auditing Standards Board (ASB)

www.aicpa.org/members/div/auditstd/drafts.htm

AICPA Accounting Standards Executive Committee (AcSEC)

www.aicpa.org/members/div/acctstd/edo/index.htm

Financial Accounting Standards Board (FASB)

www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html

Professional Ethics Executive Committee (PEEC)

www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Auditing Pipeline

Exposure Draft on Auditing Fair Value Measurements and Disclosures

.179 The AICPA's ASB has issued an exposure draft of a proposed SAS entitled *Auditing Fair Value Measurements and Disclosures*. The proposed SAS addresses auditing considerations relating to measurement, presentation, and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. A vote to ballot a document for final issuance is expected to occur in the Autumn of 2002.

New Framework for the Audit Process

.180 The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB expects to issue a series of exposure drafts in 2003. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

.181 Some of the more important changes to the standards that are expected to be proposed are:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to assessment of the risk of material misstatement of the financial statements (Among other things, this will improve the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.)
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

.182 In connection with this major initiative, the ASB and the International Auditing Practices Committee (IAPC) have agreed to form a joint task force to develop a joint standard addressing the risk assessment process. This standard will represent a significant step towards converging U.S. and international auditing standards. The standard produced by this joint task force will form the basis for the ASB's overall project.

.183 You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Accounting Pipeline

Exposure Draft on Loans and Certain Debt Securities Acquired in a Transfer (Formerly Known as Purchased Loans and Securities)

.184 The AcSEC has issued an exposure draft of a proposed SOP entitled *Accounting for Loans and Certain Debt Securities Acquired in a Transfer*. This proposed SOP considers whether Practice Bulletin (PB) No. 6, *Amortization of Discounts on Certain Acquired Loans*, continues to be relevant given a number of FASB pronouncements issued subsequent to PB No. 6. The proposed SOP excludes originated loans from its scope. A final SOP is expected to be issued during the last half of 2002.

Consolidation of Certain Special-Purpose Entities

.185 The FASB has issued an exposure draft of a proposed Interpretation of Accounting Research Bulletin (ARB) No. 51, *Consolidation of Certain Special-Purpose Entities*. This proposed Interpretation would address consolidation by business enterprises of SPEs to which the usual condition of consolidation described in ARB No. 51, *Consolidated Financial Statements*, does not apply because the SPEs have no voting interest or otherwise are not subject to control through ownership of voting interests. A final Statement is expected to be issued during the fourth quarter of 2002.

Amendment of FASB Statement No. 133 on Derivative Instruments and Hedging Activities

.186 The FASB has issued an exposure draft of a proposed Statement, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. This proposed Statement would amend the definition of a derivative in paragraph 6(b) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This proposed Statement also would amend FASB Statement No. 133 for various decisions made as part of the Derivatives Implementation Group process. A final Statement is expected to be issued during the fourth quarter of 2002.

A New Audit and Accounting Guide for Financial Institutions

.187 A new combined audit and accounting guide for financial institutions is due to be published by the AICPA in the second quarter of 2003. The Guide will reconcile guidance in the former three Audit and Accounting Guides, *Banks and Savings Institutions*, *Audits of Credit Unions*, and *Audits of Finance Companies*. More specifically, the new guide will reconcile the specialized accounting and financial reporting guidance established in the former Guides, eliminate differences in accounting and disclosure, and carry forward accounting guidance for transactions determined to be unique to certain financial institutions. The changes correspond to SOP 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*.

Resource Central

Educational courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

.188 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements:

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 123520kk.)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012541kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- *Accounting Trends & Techniques—2002*
- Audit Risk Alert *E-Business Industry Developments—2002/03* [AAM section 8210]
- *Audit and Accounting Manual* (product no. 005132kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditors' reports; checklists; and engagement letters, management representation letters, and confirmation letters.

CD-ROMS

.189 The AICPA is currently offering a 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 that includes all Guides and the related Audit 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.

.190 Additionally, *The Practitioner's Update* (product no. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Educational Opportunities

.191 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the financial institution industry. Those courses include:

- AICPA's *Annual Accounting and Auditing Workshop* (product no. 737062 [text] and 187080 [video]). Whether you are in industry or public practice, this course keeps you current, informed, and shows you how to apply the most recent standards.
- *Fair Value Accounting for Hedge Transactions* (product no. 735181). This course helps you understand GAAP for derivatives and hedging activities. Also, you will learn how to identify effective and ineffective hedges.

- *SEC Reporting* (product no. 736746). This course will help the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.
- *Depository Institutions: An Accounting and Auditing Perspective* (product no. 736092 [text] and 181791 [video]). This course provides an excellent introduction to the banking, savings institutions, and credit union industries. It will ensure that you are up-to-date and prepared for the continuing changes in this field.
- *E-Commerce: Controls and Audit* (product no. 731550). This course is a comprehensive overview of the world of e-commerce. Topics covered include internal control evaluation and audit procedures necessary for evaluating business-to-consumer and business-to-business transactions.

Member Satisfaction Center

.192 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.193 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.194 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.

Web Site Products @ AICPA Online and CPA2Biz

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- *AICPA reSOURCE Online*. Get access—anytime, anywhere—to the AICPA's latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides, Audit Risk Alerts, and *Accounting Trends & Techniques*. To subscribe to this essential service, go to www.cpa2biz.com.
- *AICPA's Online Learning Tool, AICPA Infobytes*. An annual fee (\$95 for members and \$295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.
- *AICPA Online* offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. Online informs the subscriber of developments in the accounting and auditing world as well as developments in congressional and political affairs.

Other Helpful Web Sites

.196 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the "Information Sources" table at the end of this Alert.

.197 This Audit Risk Alert replaces the *Banks, Credit Unions, and Other Lenders and Depository Institutions Industry Developments—2001/02* Audit Risk Alert. *The Banks, Credit Unions, and Other Lenders and Depository Institutions Industry Developments* 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 e-mail these comments to jgould@aicpa.org, or write to:

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Information Sources

Organization	General Information	Fax Services	World Wide Web	Recorded Announcements
American Institute of Certified Public Accountants	Order Department Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	24 Hour Fax Hotline (201) 938-3787	www.cpa2biz.com	AcSEC Telephone Line (212) 596-6008
Bank for International Settlements	Centralbahnplatz 2, Basel, Switzerland	(+41-61) 280 91 00 and (+41-61) 280 81 00	www.bis.org	
Department of Housing and Urban Development	451 7th Street SW Washington, D.C. 20410 (202) 708-1422		www.hud.gov	
Financial Accounting Standards Board	Order Department P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	Action Alert Telephone Line (203) 847-0700 (ext. 444)
Federal Financial Institutions Examination Council	Washington, D.C.		www.ffiec.gov	
Federal Home Loan Mortgage Corporation (Freddie Mac)	Customer Service 8200 Jones Branch Drive McLean, VA 22102-3107 (800) FREDDIE		www.fhlmc.org	
Federal Deposit Insurance Corporation	Public Information Center 801 17th Street, NW Room 100 Washington, D.C. 20434 (800) 276-6003 (202) 416-6940	Facsimile Bulletin Board System (804) 642-0003 / 2036	www.fdic.gov	Action Update (202) 898-7210
Federal Reserve System	Publications Services 20th and C Streets, NW Washington, DC 20551-0001 (202) 452-3245	U.S. Department of Commerce STAT-USA/FAX Some information is available to guest users. Other information requires a subscription fee. (202) 482-0005	www.frb.gov	Federal Reserve Board Highlights (202) 452-3206
Mortgage Bankers Association of America	Publications Department 1125 15th Street, NW Washington, DC 20005-2766 (800) 793-MBAA	MBA Fax on Demand This service is available only to MBA members. For more information, call (800) 909-6222.	www.mbaa.org	

(continued)

Information Sources—(cont'd)

Organization	General Information	Fax Services	World Wide Web	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	
U.S. Department of the Treasury—Office of Thrift Supervision	OTS Dissemination Branch 1700 G Street, NW Washington, DC 20552-0001 (202) 906-5900	PubliFax (202) 906-5660	www.ots.treas.gov	
U.S. Department of Education	Federal Student Aid Information Center (800) 433-3243		www.ed.gov	
U.S. General Accounting Office	Superintendent of Documents U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800	Information Line (202) 512-2250	www.gpo.gov	
United States Securities and Exchange Commission	Publications Unit 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 SEC Public Reference Room (202) 942-8078	Information Line (202) 942-8090 (ext. 3) (202) 942-8092 (tty)	www.sec.gov	Information Line (202) 942-8090 (202) 942-8092 (tty)

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AAM Section 8060

Employee Benefit Plans Industry Developments—2003

NOTICE TO READERS

This Audit Risk Alert, prepared by the AICPA staff, is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform.

This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply the SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

The AICPA staff wishes to thank the members of the Employee Benefit Plans Expert Panel; the Employee Benefit Plans Audit Guide Revision Task Force; and the Office of Chief Accountant, Employee Benefits Security Administration of the U.S. Department of Labor for their contributions to this Audit Risk Alert.

How This Alert Helps You

.01 This Audit Risk Alert is intended to help you plan and perform your employee benefit plan audits. The Alert addresses current industry developments and emerging practice issues and provides information on current auditing, accounting, and regulatory developments. Being armed with a sound understanding of these areas allows you, among other things, to perform your audits in a more efficient and effective manner, and to deliver greater value to your clients through audit and related services.

Industry and Economic Developments

.02 As traditional pension plans continue to grow more scarce, employees are using their 401(k) accounts as their main source of retirement income. The past three years have seen 401(k) portfolios shrinking and pension plans becoming underfunded. This section discusses the economic environment, pension funding crisis, and other issues facing benefit plans today.

Economic Environment

.03 In planning their audits, auditors need to understand the economic conditions facing the industry in which the client operates. Economic activities relating to such factors as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and the labor market are likely to have an impact on the entity being audited.

.04 The United States economy is in a continued state of flux. According to the Commerce Department's figures, the economy was actually shrinking in 2001, showing that the United States was in a recession long

before September 11. The events of that day certainly cost the U.S. economy thousands upon thousands of jobs and somewhere between \$75 billion and \$100 billion in reduced output. And a number of industries, such as airlines and tourism, suffered tremendously and have not fully recovered. Undoubtedly, the impact of the terrorist attacks will ripple through the economy for some time.

.05 Although the 2001 recession lasted six months longer than originally thought, it is still considered a mild recession by historical standards. Unfortunately, the recovery has been equally weak and is not typical of recoveries the country has experienced since World War II. In the past, job growth was sizable after a recession. This time, although unemployment fell to 5.6 percent in September of 2002, the trend for most of 2002 was flat. The government created most of the new jobs, and the number of jobs in the private sector actually decreased slightly. Employers are reluctant to hire new employees because of the tumbling stock market and uncertainty over the economy's health. The fourth quarter of 2002 saw the economy grow at a 1.4 percent annual rate. The historical average for economic growth at this stage of a recovery is in excess of 5 percent. The economy grew 1.6 percent in the first three months of 2003, weakened by war worries, high oil prices, and bad weather.

Stock Market Woes

.06 The downward slide of the Dow Jones Industrial Average (DJIA), the National Association of Securities Dealers Automated Quotation (NASDAQ) Composite Index, and the Standard & Poor's 500 Stock Index (S&P 500) that began in 2000 continued through 2002. Throughout the year, analysts were evaluating economic conditions and drastic declines in stock market indexes, comparing them to prior periods in an attempt to determine whether the economy had finally reached rock bottom. But the stock market kept surprising everyone with further declines that sent various indexes to record lows.

.07 Many defined benefit pension plans have experienced market value declines to the extent that plan sponsors must now make contributions (see the "Defined Benefit Plans' Pension Funding Crisis" section of this Alert for an in-depth discussion). In addition, sponsors of defined contribution pension plans are rethinking company stock versus cash matching contributions and other plan design features.

Effect of Layoffs and Cost Reductions

.08 The benefit plan administration area at a company can be especially volatile when it comes to layoffs. Significant layoffs can have a serious effect on an entity's internal control and financial reporting and accounting systems. For instance, employees who remain at the company may feel overwhelmed by their workloads, may feel pressured to complete their tasks with little or no time to consider their decisions, and may be performing too many tasks and functions. The auditor may need to consider whether these situations exist and what their effect on internal control may be. Statement on Auditing Standards (SAS) No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, 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).

.09 Additionally, the auditor may need to consider the possible effects that key unfilled positions can have on internal control. Entities that have had strong financial reporting and accounting controls could see those controls deteriorate due to the lack of employees. Layoffs as well as the current economic climate can also create additional exposure to possible internal fraudulent activities (for example, when an employee performs a job function that otherwise would be segregated). SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by fraud. See the section "Consideration of Fraud in Employee Benefit Plan Engagements" in this Alert for further discussion of SAS No. 99.

.10 You may want to consider these issues in planning and performing the audit and in assessing control risk. Remember that gaps in key positions may represent reportable conditions that should be communicated

to management and the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

.11 In addition, significant layoffs could result in a change in benefit plan activity (for example, decreased contributions or increased distributions) that should be considered in planning and performing the plan audit.

.12 Some companies have chosen to reduce operating costs by decreasing/eliminating employer matching contributions or amending employee benefit plans to allow for payment of expenses from the plan instead of from the plan sponsor. There has been a trend toward defined contribution plans charging participants for expenses or paying expenses out of plan forfeitures. In addition, to reduce costs, health and welfare plans are increasing premium copayments or health insurance deductibles or lowering health coverage limits. Such changes in plan administration should be reviewed to determine whether they are in accordance with the plan document and should be considered in planning and performing the audit.

The Sarbanes-Oxley Act of 2002

.13 On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the Act). The Act dramatically affects the accounting profession and affects not just the largest accounting firms, but any CPA actively working as an auditor of or for a publicly traded company or any CPA working in the financial management area of a public company. The Act contains some of the most far-reaching changes that Congress has ever introduced to the business world. Although most of the provisions of this legislation are specific to auditors of public companies, even practitioners not performing audits may be affected by the Act. Therefore, all CPA firms should become familiar with the provisions of the Act.

Timetable

.14 For a timetable of key actions to be taken in response to the Act and for information about what auditors need to know, go to www.aicpa.org/sarbanes/index.asp.

Major Provisions

.15 Major provisions of the Act include:

- A new Public Company Accounting Oversight Board (PCAOB) of five members has been appointed and is overseen by the Securities and Exchange Commission (SEC). This new board will be funded by public companies through mandatory fees.
- Auditors of public companies will be required to register with the board. This includes auditors of employee benefit plans whose plan sponsors file Form 11-Ks with the SEC.
- The board has the authority to set and enforce auditing, attestation, ethics, and quality control standards for audits of public companies.
- The Act requires the board to include in auditing standards certain requirements, such as:
 - Retention of the audit working papers for a seven-year period
 - A concurring or second partner review of audit reports
 - A description in the auditor's report of the scope of the auditor's testing of the internal control structure and procedures of the issuer
- The Act requires inclusion in the auditor's report or in a separate report of (1) the findings of the auditor's testing of internal controls; (2) an evaluation of (a) whether the internal control structure and procedures include maintenance by the issuer of records that accurately and fairly reflects the transactions and disposition of assets and (b) whether the issuer's internal controls provide reasonable

assurance that transactions are recorded in conformity with generally accepted accounting principles (GAAP), and that receipts and expenditures are being made only in accordance with authorizations of management and directors; and (3) a description, at a minimum, of material weaknesses in internal controls.

- The board is empowered to inspect the auditing operations of public accounting firms and to investigate violations of securities laws, standards, competency, and conduct.
- The board can impose disciplinary or remedial sanctions for violations of the board's rules, securities laws related to public company audits, and professional accounting standards. The board will perform annual quality reviews (inspections) for the largest audit firms (more than 100 issuers); smaller firms must be inspected every three years.
- The Act restricts the consulting work auditors may perform for a public company it audits. Banned nonaudit services include bookkeeping, information systems design and implementation, appraisals or valuation services, actuarial services, internal audits, management and human resources services, broker/dealer and investment banking services, legal or expert services unrelated to audit services, and other services the board determines by rule are impermissible. Nonaudit services not banned are allowed if preapproved by the audit committee.
- Audit committees of the company's board of directors are responsible for the hiring, compensation, and oversight of the independent auditor.
- Chief executive officers (CEOs) and chief financial officers (CFOs) are required to certify company financial statements, with criminal (up to 20 years) and civil (up to \$5 million) penalties for false certification. In the event of a restatement of financial statements arising from securities fraud, CEOs and CFOs must forfeit trading profits and bonuses received before the restatement. Presently, this requirement under section 302 of the Act does not apply to Form 11-K filings. It is unclear if certifications pursuant to section 906 of the Act apply to Form 11-K filings. SEC council should be consulted for this regulation.
- Document altering or destroying in a federal or bankruptcy investigation is now a felony with penalties of up to 20 years. Key audit documents and e-mail must be preserved for five years. It is a felony, with penalties of up to 10 years, to destroy such documents. There is also a provision that requires retention of key audit documents, as defined by the SEC, for seven years.
- The statute of limitations for the discovery of fraud is extended to two years from the date of discovery and five years after the act. (It was previously one year from discovery and three from the act.)

To read a detailed description of the Sarbanes-Oxley Act, go to www.aicpa.org/info/sarbanes_oxley_summary.htm.

Ramifications and Rulemaking

.16 The ramifications of some of the provisions in the Sarbanes-Oxley Act will become known only as the SEC and the new PCAOB begin implementing the law. In response to the Act, the SEC has issued a number of rulings.

Cascade Effect

.17 Of particular concern is just how far down the Act will cascade, affecting the nation's small and midsized accounting firms of nonpublic companies. A major concern is that the new legislation by Congress may become the template for parallel federal and state legislative or rule changes that directly affect both nonpublic companies that are subject to other regulations and the CPAs that provide services to them.

.18 Section 209 of the Act states:

In supervising nonregistered public accounting firms and their associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable, particularly taking into consideration the size and nature of the business of the accounting firms they supervise and the size and nature of the business of the clients of those firms.

.19 As we write, several states are moving forward with legislation that could result in additional burdens for CPAs and possibly conflict with federal laws. The AICPA and the state CPA societies are monitoring this situation closely and will continue to keep you informed.

Audit Engagement Changes Resulting From Sarbanes-Oxley

.20 Currently, the AICPA Auditing Standards Board (ASB) is considering the Act's provisions and its audit implications. Issues being addressed include:

1. A possible amendment to SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), to address the audit working paper retention provisions of the Act
2. Amendments to the attestation standards (Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification* [AICPA, *Professional Standards*, vol. 1, AT sec. 501]) in light of the Act's provisions regarding internal control reporting
3. Possible changes to auditing and quality control standards to respond to the Act's provisions concerning audit partner rotation, concurring review partner reviews, and quality control
4. Possible changes to auditing standards in response to communication and reporting needs of audit committees

Your Professional Resource

.21 To help you understand the ramifications of the Sarbanes-Oxley Act and to help you comply with its provisions, the AICPA is developing several resources, including the following:

1. A new toll-free number is available for any questions your firm or company may have about the legislation, how it will be implemented, and how to comply. Call (866) 265-1977 and select the option that is most appropriate for your firm or company. You will receive a response within 24 hours.
2. The AICPA has established the "Sarbanes-Oxley Act/PCAOB Implementation Central" at AICPA Online at www.aicpa.org/sarbanes/index.asp to keep you up-to-date on important developments.
3. Periodic Web casts will be conducted to brief members on issues as they emerge, as well as short video clips and news alerts that will be sent to members through e-mail.
4. A one-hour CPE training course on the legislation has been developed.
5. Updates and information will be published in numerous newsletters and other communication channels, including AICPA Online, the *CPA Letter*, and the *Journal of Accountancy*.

Defined Benefit Plans' Pension Funding Crisis

.22 As the stock market has plummeted, so has the value of pension plan assets. Suddenly, entities are faced with the prospect of pouring money into underfunded pension plans. These contributions will reduce earnings, perhaps significantly. In addition, companies with underfunded pension plans face the risk of technically defaulting on the debt they carry. Thus, a going-concern problem can arise.

Impact on the Plan Sponsor

.23 The funded status of most defined benefit pension plans has flipped from overfunded to underfunded since the beginning of 2000, and plan sponsor contributions may now be required. The decline of the

equity markets is well recognized as a cause of the reversal, with the S&P 500 Stock Index declining 40 percent over that three-year period. Less recognized but of great impact is the lower interest rates used to present value the pension obligation. As a rule of thumb, for every 1 percent drop in the discount rate, the pension obligation increases by 15 percent to 20 percent.

.24 The impact on a plan sponsor's financial statements has been dramatic, increasing pension expense (and thus lowering earnings per share), and in many cases causing an additional minimum liability to be recorded for the first time ever. When the market value of plan assets under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions*, falls below the accumulated plan obligation (APO), the deficiency, along with any prepaid pension cost, is recorded as additional liability, and for some companies, a portion of the additional liability is recorded as a reduction in shareholders' equity. The decreased equity affects the debt-to-equity ratio, which may cause debt covenant violations.

Illustrative Statement of Changes in Net Assets Available for Benefits With Negative Returns

.25 With the continued decline in value of plan investments, many plans have investment losses. The following financial statement shows the presentation of investment losses on a statement of changes in net assets available for benefits.

ABC, Inc. 401(k) Employee Savings Plan Statement of Changes in Net Assets Available for Benefits (Modified Cash Basis)		
	Years ended December 31,	
	20X2	20X1
Investment income (loss):		
Interest and dividend income	\$ 1,302,277	\$ 475,195
Net depreciation in fair value of investments	(5,206,577)	(1,888,439)
Other income—loan interest	15,488	9,805
Total investment loss	(3,888,812)	(1,403,439)
Contributions:		
Employee	6,777,195	5,489,673
Employer	2,483,755	865,479
Rollover	467,288	672,053
Total contributions	9,728,238	7,027,205
	5,839,426	5,623,766
Deductions from net assets attributable to:		
Benefits paid	3,796,126	2,947,410
Administrative expenses (note 4)	5,465	2,345
Total deductions	3,801,591	2,949,755
Net increase	2,037,835	2,674,011
Net assets available for benefits:		
Beginning of year	21,907,630	19,233,619
End of year	<u>\$23,945,465</u>	<u>\$21,907,630</u>

See accompanying notes to financial statements.

Investments in Limited Partnerships and Reporting Such Investments on Form 5500 and 103-12 Entities

.26 Pension funds, especially those with large investment portfolios, are more frequently investing in limited partnership private equity funds, which may include hedge funds. These pooled investment funds are lightly regulated and not readily marketable, unlike registered investment funds, commonly known as mutual funds. Auditors should take special care in identifying when a plan invests in a limited partnership because it is not uncommon for such investments to be classified incorrectly (for example, as a registered investment company or other type of fund) on the schedule of investments provided by the custodian or trustee.

.27 This trend of investing in limited partnerships and the recent scrutiny of accounting and disclosure of limited partnership investments in corporate financial statements have precipitated an issue about what employee benefit plan financial statements should disclose about a plan's investments in limited partnerships.

.28 The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (EBP Guide), does not specifically address financial statement or Form 5500 reporting requirements for limited partnerships. Employee benefit plan financial statements report investments at fair value, which would include investments in limited partnerships. Such investments are not consolidated or accounted for on the equity method, as they might be in the plan sponsor's financial statements.

.29 Other required disclosures for limited partnership investments are those applicable under AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. SOP 94-6 requires disclosures about certain significant estimates and current vulnerability due to certain concentrations.

.30 Consideration should be given to including the following disclosures:

- Description of the plan's ownership interests in the limited partnerships and a summary of investments owned by the partnership investments and the corresponding risk. A riskier, more aggressive investment would warrant consideration of additional disclosure.
- If a related party relationship exists, the names of the other partners in the plan's partnership investments and their relationship to the plan.
- Methodology in which the partnerships allocate gains, losses, and expenses between the plan and the other partners.
- Related-party transactions with parties in interest related to the limited partnerships (including investment management fees paid).
- Additional capital commitment requirements.

.31 Paragraph 7.57 of the EBP Guide addresses auditing procedures for limited partnerships when performing full scope audits. Auditors should take special care in performing limited scope audit procedures on limited partnership investments, as often the certifying entity does not have timely or accurate information regarding the amount and valuation of the plan's investment in the limited partnership. Although the auditor is not required to audit certain investment information when the limited scope audit exemption is applicable, further investigation and testing are required whenever the auditor becomes aware that such information is incorrect, incomplete, or otherwise unsatisfactory for the purpose of preparing the financial statements (see paragraph 7.62 of the EBP Guide.)

.32 How a plan reports an investment in a limited partnership on Schedule H to the Form 5500 depends on the nature of the underlying assets of the partnership and whether the partnership elects to file directly with the Department of Labor (DOL).

Financial Statement Reporting and Form 5500 Filing Requirements for 103-12 Entities

.33 DOL regulation 29 CFR 2520.103-12 provides an alternative method of reporting for plans that invest in an entity, other than a master trust investment account (MTIA), common/collective trust (CCT), or pooled separate account (PSA), whose underlying assets include “plan assets” (within the meaning of DOL regulation 29 CFR 2510.2-101) of two or more plans that are not members of a related group of employee benefit plans. Making this determination can be complicated and may necessitate legal consultation.

.34 Generally a 103-12 entity will operate based on its legal structure (according to its operating agreements) in the form of a financial services product such as a collective trust or a limited partnership. Typically audited financial statements are required by the entity’s operating agreement and are prepared in accordance with generally accepted accounting principles in a format following industry standards consistent with the entity’s operations. For example, a 103-12 entity that operates as a limited partnership would prepare financial statements in accordance with GAAP for limited partnerships.

.35 103-12 entities are required to file the following (see paragraph A.56 of the EBP Guide):

- Form 5500
- Schedule A, Insurance Information
- Schedule C, Service Provider Information, Part I and II
- Schedule D, DFE/Participating Plan Information, Part II
- Schedule H, Financial Information (including the Schedule of Assets (Held at End of Year))
- Schedule G, Financial Transaction Schedules
- A report of the independent qualified accountant

.36 Often the format of the financial statement schedules (for example, the Schedule of Assets) for the 103-12 entity prepared in accordance with industry standards are not consistent with format of the schedules as required by Form 5500 instructions. Form 5500 requirements should be considered when preparing additional information schedules to be attached to the 103-12 entity’s financial statements filed with the Form 5500.

Outsourcing of Certain Administrative Functions

.37 Employee benefit plan sponsors have typically used third-party service providers in some capacity to assist in administering their plans. With the trend toward company downsizing and increased reliance on technology, many plan sponsors are increasingly turning to outsourcing as a way to reduce costs and increase efficiencies of administering employee benefit plans. Examples include recordkeeping and/or benefit payments or claims processed by outside service organizations, such as bank trust departments, data processing service bureaus, insurance companies, and benefits administrators.

.38 Many plan sponsors and their employees may not be familiar with their fiduciary responsibilities regarding employee benefit plans. Auditors should refer plan sponsors to their plan legal counsel for interpretations of specific actions and how these may or may not be in accord with their fiduciary responsibilities.

.39 SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, provides, among other things, guidance on the factors an independent auditor should consider when auditing the financial statements of a plan that uses a service organization to process certain transactions. Often, the plan does not maintain independent accounting records of transactions executed by the service provider. For example, many plan sponsors no longer maintain participant enrollment forms detailing the

contribution percentage and the allocation by fund option; these amounts can be changed by telephone or over the Internet without any record. In these situations, the auditor may not be able to obtain a sufficient understanding of internal control relevant to transactions executed by the service organization to plan the audit and to determine the nature, timing, and extent of testing to be performed without considering those components of internal control maintained by the service organization. This understanding can be efficiently achieved by obtaining and reviewing a report prepared in accordance with SAS No. 70, if available. If a SAS No. 70 report is not available, see paragraph 6.14 of the EBP Guide for guidance.

.40 The auditor should read the entire SAS No. 70 document to determine what was reviewed and tested and over what period and whether there are any instances of noncompliance with the service organization's controls identified in either (1) the service auditor's report or (2) the body of the document (where the 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 at 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.

.41 The plan auditor should also read the description of controls to determine whether complementary user organizations controls are required (for example, at the plan sponsor level) and whether they are relevant to the service provided to the plan. If they are relevant to the plan, the plan auditor should consider such information in planning the audit. The plan auditor should consider the need to document and test such user organization controls. While the plan sponsor may have outsourced administrative functions to a third party, the plan sponsor still has a fiduciary duty to monitor the activities of the third party. Examples of such monitoring controls, which should be considered in planning and performing the audit, may include:

- Review of third-party service provider's SAS No. 70 report
- Fluctuation analysis or reasonableness review of periodic third-party service provider reports with reconciliations with and comparisons to client data
- Predetermined communication, escalation, and "follow-up" procedures in the event of an issue or problem
- Periodic review of financial and control measures included in the third-party service provider contract
- On-site visits to the third-party service provider
- Annual reassessment of effectiveness of the third-party service provider relationship

What If the Service Organization Uses Another Service Organization to Perform Certain Functions?

.42 A service organization may use another service organization to perform functions or processing that is part of the plan's information system as it relates to an audit of the financial statements. The subservice organization may be a separate entity from the service organization or may be related to the service organization. To plan the audit and assess control risk, the plan auditor may need to consider controls at the service organization and also may need to consider controls at the subservice organization, depending on the functions each performs. For further guidance on subservice organizations, see paragraph 6.17 of the EBP Guide and chapter 5 in the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772).

Going-Concern Issues for Plans

.43 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), as amended, provides guidance to auditors with respect to evaluating whether there is substantial doubt about the plan's ability to continue as a going concern. For financial reporting purposes, continuation of a plan as a going concern is assumed in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going concern assumption relates to:

- The plan's ability to continue to meet its obligations as they become due without an extraordinary contribution by the sponsor or substantial disposition of assets outside the ordinary course of business.
- Externally forced revision of its operations, or similar actions.

.44 During the course of the audit, the auditor may become aware of information that raises substantial doubt about the plan sponsor's ability to continue as a going concern. Although employee benefit plans are not automatically and necessarily affected by the plan sponsor's financial adversities, the auditor should address whether those difficulties pose any imminent, potential impact on the plan and should consider the sponsor's plans for dealing with its conditions. Due to the current economic climate, some plan sponsors are filing for bankruptcy, causing the plan to liquidate and pay out all of the participants. Plan expenses may increase if the costs of winding down the plan are paid out of plan assets (if permitted by the plan document).

.45 SAS No. 59, as amended, states that the auditor has a responsibility to evaluate whether there is substantial doubt about the plan'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 auditor considers the results of the procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit to identify conditions and events that, when considered in the aggregate, create substantial doubt about the plan's ability to continue as a going concern for a reasonable period of time. As noted earlier, such conditions may include the need for an extraordinary contribution from the plan sponsor and/or the need to dispose of substantial assets outside the ordinary course of business. Other such conditions and events may include:

- The plan's inability to make benefit payments when they are due
- Plan merger or consolidation
- Debt restructuring
- Loan defaults
- The plan's inability to meet minimum funding requirements
- Bankruptcy of the plan sponsor (or participating employers in multiemployer plans)
- A nontemporary decline in the market value of investments held by the plan
- A significant increase in the cost of benefits without the ability to significantly raise contributions
- Events that endanger the plan's ability to operate, such as if the plan no longer qualifies as a qualified plan

.46 If the auditor determines that substantial doubt about the plan's ability to continue as a going concern does exist, an explanatory paragraph in the auditor's report is required regardless of the auditor's assessment of asset recoverability and amount and classification of liabilities. For example, if the sponsoring employer intends to terminate the plan within 12 months of the date of the financial statements, the auditor should include an explanatory paragraph in his or her report that discloses that fact. SAS No. 59 is amended to preclude the use of conditional language in expressing a conclusion concerning the existence of substantial doubt about the plan's ability to continue as a going concern in a going-concern explanatory paragraph.

The Health Insurance Portability and Accountability Act

.47 The Health Insurance Portability and Accountability Act of 1996 (HIPAA) established standards for the privacy and protection of individually identifiable electronic health information as well as administrative simplification standards. HIPAA includes protection for those who move from one job to another, who are self-employed, or who have preexisting medical conditions, and places requirements on employer-sponsored group health plans, insurance companies, and health maintenance organizations.

.48 In December 2000 the final rules on standards for privacy of individually identifiable health information were published in the *Federal Register*. The rules include standards to protect the privacy of individually identifiable health information. The rules (applicable to health plans, health care clearinghouses, and certain health care providers) present standards with respect to the rights of individuals who are the subjects of this information, procedures for the exercise of those rights, and the authorized and required uses and disclosures of this information. These are the first-ever national standards to protect medical records and other personal health information.

.49 The new standards:

- Limit the nonconsensual use and release of private health information.
- Give patients new access to their records and let them know who else has accessed them.
- Restrict most disclosure of information to the minimum needed for the stated purpose.
- Establish criminal and civil sanctions.
- Establish requirements for access by researchers and others.

Providers will be required to obtain advance written consent from their patients to disclose information and to provide those patients with written information on their privacy rights.

.50 The regulations became effective April 14, 2001; however, health care providers were not forced to fully comply with the changes until April 14, 2003.

.51 In response to this regulation, many claim processors have updated and instituted a variety of confidentiality, indemnification, or business associates agreements to protect their organizations when third parties request claim information. In certain instances the auditor has been willing to sign such contracts but the third-party administrator has interpreted the new HIPAA regulations to not allow outside auditors access to the detail claims information. However, some believe that as long as the health information is protected by a privacy contract signed by the auditor, the third-party administrator should provide access to a plan's claim information for purposes of performing an audit of the plan's financial statements to be attached to the Form 5500 filing with the DOL.

.52 On February 20, 2003 the security rules under HIPAA were finalized. The rules are effective for most health plans on April 21, 2005 (small health plans, as defined, will have until April 21, 2006 to comply).

.53 If the auditor is unable to obtain access to records as a result of (1) not signing a confidentiality agreement or (2) a third party administrator's refusal to provide access under any circumstances, a scope limitation could result.

.54 (See the discussion of confidentiality agreements in the section "Health and Welfare Benefit Plan Issues—Confidentiality, Indemnification, and Business Associates Agreements" of this Alert.)

GUST

.55 GUST is an acronym for the following laws that have changed plan qualification requirements:

- General Agreement on Tariffs and Trade—Uruguay Round Agreements Acts (GATT)
- Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA)
- Small Business Job Protection Act of 1996 (SBJPA)
- Taxpayer Relief Act of 1997 (TRA '97)
- IRS Restructuring and Reform Act of 1998 (RRA '98)
- Community Renewal Tax Relief Act of 1997 (CRA)
- Community Renewal Tax Relief Act of 2000 (as added by Rev. Proc. 2001-55)

.56 All plan documents, including those for prototype plans, must be amended to comply with the applicable legislative changes required by GUST. A prototype plan is typically a retirement plan prepared by a bank, securities firm, or other financial institution that may be adopted by an employer. Like all plans, prototype plans must be amended from time to time as required by changing legislation and regulations. Auditors should be aware that if plans are not restated in a timely manner to comply with GUST, the plan sponsor risks losing its plan's tax-qualified status.

.57 Revenue Procedure 2001-55 extended the remedial amendment period to February 28, 2002 (if the period would have otherwise ended before then). Also extended to February 28, 2002, was the time for adoption of a preapproved prototype plan or certification of intent to adopt such a plan in order to be eligible for the extension of the GUST remedial amendment period (later of December 31, 2002 or one year from receipt of a GUST opinion letter). Revenue Procedure 2002-73 further extended this time to the later of September 30, 2003 or the end of the 12th month after the date the sponsor receives a GUST opinion or advisory letter from the IRS, for amending preapproved plans to comply with GUST.

Regulatory Developments

PWBA Becomes the Employee Benefits Security Administration

.58 Effective February 3, 2003, the DOL changed the name of the Pension and Welfare Benefits Administration (PWBA) to the Employee Benefits Security Administration (EBSA). According to EBSA Assistant Secretary Ann L. Combs, "This action helps us achieve our goal of improved public service by making the agency more recognizable to those we serve. We want to enable Americans to better identify the federal agency that assists them in understanding and receiving their benefits."

.59 EBSA will continue to meet the ever-increasing demand to assist workers with their health and retirement benefits. The agency will continue its outreach activities to educate individuals and the business community about its programs, services, and relevant federal law, and help employers and service providers comply with their obligations under the law. During 2002, over 184,000 individuals contacted the agency for assistance.

.60 The public may reach EBSA by using the existing telephone, e-mail, and Web site contacts for PWBA. The agency is initiating a new toll-free participant assistance number, (866) 444-EBSA (3272), a new address for electronic inquiries, www.askebsa.dol.gov, and a new address for its Web site, www.dol.gov/ebsa. To reduce paperwork and costs, employers and plans will not be required to modify existing summary plan descriptions to reflect the agency's name change.

2002 Form 5500 Series

.61 The DOL, Internal Revenue Service (IRS), and the Pension Benefit Guaranty Corporation (PBGC) have released the 2002 Form 5500 return/reports, schedules, and instructions to be used by employee benefit plans for plan year 2002 filings. The IRS has also released the Form 5500-EZ return and instructions to be used by certain one-participant retirement plans for plan year 2002 filings.

.62 The Form 5500 and Form 5500-EZ for plan year 2002 are essentially unchanged from 2001. Certain modifications have been made to reflect changes in the law or regulations, to improve forms processing and to clarify the instructions. Modifications include, among other things:

- Redesign of the signature areas on the Form 5500, Form 5500-EZ, and Schedules B, P, and SSA to highlight where to sign the forms;
- Addition of several new principal business activity codes for Form 5500, line 2d, and several new plan characteristics codes for lines 8a and 8b;
- Removal of lines 8c and 10c of Form 5500 and Schedule F as a result of IRS Notice 2002-24 that suspended the filing requirements for fringe benefit plans;
- Elimination of several lines from Schedules B and R due to the phasing out of certain rules under Internal Revenue Code section 412(l) and Employee Retirement Income Security Act (ERISA) section 302(d);
- Addition of lines 16a through 16c and 17a through 17e to Schedule E concerning employee stock option plans (ESOPs) maintained by S Corporations;
- Modification of Schedules H and I line 4a to highlight EBSA's Voluntary Fiduciary Correction Program (VFCP) and Prohibited Transaction Exemption (PTE) 2002-51; and
- Advising Schedule SSA filers who need to report more separated participants than Schedule SSA (page 2) allows that the Social Security Administration requires that filers use additional Schedule SSA (page 2) as attachments.

.63 The DOL's ERISA Filing Acceptance System (EFAST) continues to process the Form 5500 in two computer scannable formats: *machine print* and *hand print* (the questions are the same, only the appearance is different). Machine print forms are completed using computer software from EFAST approved vendors and can be filed electronically or by mail (including certain private delivery services). Hand print forms may be completed by hand, typewriter, or by using computer software from EFAST approved vendors. Hand print forms can be filed by mail (including certain private delivery services); however, they *cannot* be filed electronically.

.64 The list of approved software vendors on the EFAST Web site is updated as software is approved for plan year 2002 filings. For assistance, filers may also contact EBSA's help desk toll free at (866) 463-3278.

.65 Information copies of the forms, schedules, and instructions are available on EBSA's Web site at www.efast.dol.gov. Filers may also order forms and IRS publications 24 hours a day, seven days a week, by calling (800) TAX-FORM (800-829-3676).

Department of Labor Amends EXPRO

.66 On July 2, 2002, the DOL finalized an amendment to PTE 96-62, known as EXPRO, to streamline the process for parties to seek authorization from the DOL to engage in certain prohibited transactions. The exemption applies to certain prospective transactions between employee benefit plans and parties in interest where such transactions are specifically authorized by the DOL and are subject to terms, conditions, and representations that are substantially similar to exemptions previously granted by the DOL. The exemption

affects plans, participants, and beneficiaries of such plans and certain persons engaging in such transactions.

.67 PTE 96-62 requires that applicants demonstrate to the DOL that their proposed transactions are substantially similar to transactions in at least two exemptions previously granted by the department within five years of their submission. The amendment provides applicants with more cases on which to base their transactions. The amendment to EXPRO also provides applicants with an alternate method of satisfying the program's requirements: Instead of having to cite as substantially similar two individual exemptions granted by the DOL within the previous five years, applicants may cite one individual exemption granted within the past 10 years and a transaction "authorized" under the EXPRO exemption within the past five years.

.68 To date, over 200 EXPRO transactions have been authorized. EXPRO has significantly reduced the number of individual exemptions relating to routine transactions, thus allowing applicants to receive exemptions in a more timely fashion and often saving them the cost of going through the more formal process for exemptions.

.69 For more information about EXPRO and the transactions authorized under the program, visit EBSA's Web site at www.dol.gov/ebsa.

Small Pension Plan Security Regulation

.70 On October 19, 2000, the DOL published a final rule to improve the security of the more than \$300 billion in assets held in private-sector pension plans maintained by small businesses. In recent years, considerable public attention has focused on small plans' potential vulnerability to fraud and abuse. Although such circumstances are rare, the DOL decided it was appropriate to strengthen the security of pension assets and the accountability of persons handling those assets.

.71 Historically, pension plans with fewer than 100 participants have been exempt from the requirement to have an independent audit of the plan's financial statements. This regulation is designed to safeguard small pension plan assets by adding conditions to the audit waiver requirement that focus on persons who hold plan assets, enhanced disclosure to participants and beneficiaries, and improved bonding requirements. The audit requirement for health and welfare plans is not affected by this regulation.

.72 Under the regulation, the administrator of an employee pension benefit plan that is required to complete Schedule I of the Form 5500 is not required to engage an independent auditor provided:

- At least 95 percent of the assets of the plan constitute "qualifying plan assets;" or
 - Any person who "handles" assets of the plan that do not constitute qualifying plan assets is bonded in accordance with ERISA section 412 and DOL Regulation 29 CFR 2580.412-6;
- and
- Certain required disclosures are made in the plan's summary annual report (SAR).

According to the DOL, the vast majority of the assets of small plans are "qualifying plan assets." The DOL believes that the plans that do not meet the 95 percent threshold will opt for the less expensive bonding alternative to avoid an independent audit of the plan's financial statements.

Definition of Qualifying Plan Assets

.73 For purposes of this regulation, the term *qualifying plan assets* means:

- Qualifying employer securities, as defined in ERISA section 407(d)(5) and the regulations issued there under;

- Any loan meeting the requirements of ERISA section 408(b)(1) and the regulations issued there under;
- Any assets held by any of the following institutions:
 - A bank or similar financial institution as defined in section 2550.408b-4(c);
 - An insurance company qualified to do business under the laws of a state;
 - An organization registered as a broker-dealer under the Securities Exchange Act of 1934; or
 - Any other organization authorized to act as a trustee for individual retirement accounts under Internal Revenue Code section 408.
- Shares issued by an investment company registered under the Investment Company Act of 1940;
- Investment and annuity contracts issued by any insurance company qualified to do business under the laws of a state; and
- In the case of an individual account plan, any assets in the individual account of a participant or beneficiary over which the participant or beneficiary has the opportunity to exercise control and with respect to which the participant or beneficiary is furnished with, at least annually, a statement from a regulated financial institution describing the assets held (or issued) by such institution and the amount of such assets.

Disclosure Requirements

.74 The exemption from the audit requirement for small pension plans is further conditioned on the disclosure of certain information to participants and beneficiaries. Specifically, the SAR of a plan electing the waiver must include, in addition to any other required information:

- Except for qualifying plan assets, as previously described, the name of each regulated financial institution holding (or issuing) qualifying plan assets and the amount of such assets reported by the institution as of the end of the plan year;
- The name of the surety company issuing the bond, if the plan has more than 5 percent of its assets in nonqualifying plan assets;
- A notice indicating that participants and beneficiaries may, upon request and without charge, examine, or receive copies of, evidence of the required bond and statements received from the regulated financial institutions describing the qualifying plan assets; and
- A notice stating that participants and beneficiaries should contact the EBSA regional office if they are unable to examine or obtain copies of the regulated financial institution statements or evidence of the required bond, as applicable.

.75 In response to a request from any participant or beneficiary, the administrator, without charge to the participant or beneficiary, must make available for examination, or upon request furnish copies of, each regulated financial institution statement and evidence of any bond required.

Effective Date

.76 The amendments made by this final rule are applicable as of the first plan year beginning after April 27, 2001. Accordingly, this change applied to the 2001 year filings for fiscal year filers whose plan years begin after April 27, 2001, and the 2002 filings for calendar year filers.

.77 Plan auditors should advise their small plan clients that they must indicate on Schedule I, Item 4k, whether they are claiming a waiver of the audit requirement.

Help Desk—See *Appendix D* of this Alert for a summary of the small pension plan audit waiver (SPPAW) in decision tree format.

DOL Guidance on Claims Regulation

.78 On November 21, 2000, the DOL published in the *Federal Register* a final regulation that sets new standards for processing benefit claims of participants and beneficiaries who are covered under employee benefit plans governed by ERISA. The regulation may be found at the DOL's Web site at www.dol.gov/ebsa/regs/fedreg/final/2000029766.htm.

.79 The new claims procedure regulation began to apply to some plans for new claims filed on or after January 1, 2002, and began to apply to group health plans on the first day of the first plan year beginning on or after July 1, 2002, but not later than January 1, 2003. The claims procedure regulation changes the minimum procedural requirements for the processing of benefit claims for all employee benefit plans covered under ERISA, although the changes are minimal for pension and welfare benefits plans other than those that provide group health and disability benefits. For group health and disability benefit claims, the regulation substantially changes the procedures for benefit determinations. Among other things, it creates new procedural standards for initial and appeal-level decisions, new time frames for decision making, and new disclosure rights for claimants.

.80 In response to many questions, the DOL has also published new guidance, in a Q & A format, to assist plans in bringing their benefit processing systems into timely compliance with the requirements of the claims regulation. This new guidance answers many of the frequently asked questions about the application of the claims regulation to group health and disability benefit plans. To the extent that the provisions of the regulation apply to other types of plans, the Q & A guidance applies to those plans also. The DOL anticipates providing additional guidance in the form of additional questions and answers, advisory opinions, or information letters as may be necessary to facilitate implementation of the requirements of the regulation. The views expressed in this publication represent the views of the DOL and may be obtained on the Internet at www.dol.gov/dol/ebsa or by calling the DOL toll free at (800) 998-7542 to obtain free printed copies.

EBSA Review of Plan Audits

.81 The EBSA continues its ongoing quality review program to assess the quality of ERISA audits. EBSA staff review audit reports that are attached to Form 5500 filings as well as conduct on-site reviews of audit work papers.

.82 In January 2003, the agency also began a nationwide study involving the on-site review of approximately 300 randomly selected sets of ERISA audit working papers. The primary objective of this review is to assess whether the level and quality of audit work being performed by Independent Qualified Public Accountants has improved as a result of actions taken by the DOL and the accounting and auditing profession since the performance of a similar study in 1997. That study disclosed that 19 percent of the audits pertaining to the 1992 filing year failed to comply with one or more of the established professional standards, and 33 percent of the audit reports reviewed failed to comply with one or more of ERISA's reporting and disclosure requirements.

EBSA Outreach and Customer Service Efforts

.83 The EBSA continues to encourage auditors and plan filers to call its Division of Accounting Services at (202) 693-8360 with ERISA-related accounting and auditing questions. Questions concerning the filing requirements and preparation of Form 5500 should be directed to the EBSA's EFAST help desk at its toll-free number, (866) 463-3278.

.84 In addition to handling technical telephone inquiries, the EBSA is involved in numerous outreach efforts designed to provide information to practitioners to help their clients comply with ERISA's reporting and disclosure requirements. The agency's outreach efforts continue to feature the current Form 5500, the EFAST processing system, and other agency-related developments. Questions regarding these outreach efforts

should be directed to the Office of the Chief Accountant at (202) 693-8360. Practitioners and other members of the public may also wish to contact the EBSA at its Web site at www.dol.gov/dol/ebsa. The Web site also provides information on EBSA's organizational structure, current regulatory activities, and customer service and public outreach efforts.

Delinquent Filer Voluntary Compliance Program

Help Desk—While more common for pension plans, this program also covers delinquent contributions made to health and welfare plans.

.85 The Delinquent Filer Voluntary Compliance (DFVC) Program is designed to encourage plan administrators to file overdue annual reports by letting them pay reduced penalties. Established in 1995, the program was revised in March 2002 to increase the incentives for delinquent plan administrators to voluntarily comply with ERISA's annual reporting requirements. Specifically, the DOL further reduced penalties under the DFVC program, and updated and simplified the rules governing participation in the program.

Program Eligibility

.86 Eligibility in the DFVC program continues to be limited to plan administrators with filing obligations under Title I of ERISA who comply with the provisions of the program and who have not been notified in writing by the DOL of a failure to file a timely annual report under Title I of ERISA. For example, Form 5500-EZ filers and Form 5500 filers for plans without employees (as described in 29 CFR 2510.3-3(b) and (c)), are not eligible to participate in the DFVC program because such plans are not subject to Title I.

Program Criteria

.87 Participation in the DFVC program is a two-part process. First, file with EBSA a complete Form 5500 Series Annual Return/Report, including all schedules and attachments, for each year relief is requested. Special simplified rules apply to "top hat" plans and apprenticeship and training plans. Second, submit to the DFVC program the required documentation and applicable penalty amount. The plan administrator is personally liable for the applicable penalty amount, and, therefore, amounts paid under the DFVC program shall not be paid from the assets of an employee benefit plan.

Penalty Structure

.88 *Reduced Per-Day Penalty.* The basic penalty under the program was reduced from \$50 to \$10 per day for delinquent filings.

.89 *Reduced Per-Filing Cap.* The maximum penalty for a single late annual report was reduced from \$2,000 to \$750 for a small plan (generally a plan with fewer than 100 participants at the beginning of the plan year) and from \$5,000 to \$2,000 for a large plan.

.90 *Per-Plan Cap.* The revised DFVC program also includes a per-plan cap. This cap is designed to encourage reporting compliance by plan administrators who have failed to file an annual report for a plan for multiple years. The per-plan cap limits the penalty to \$1,500 for a small plan and \$4,000 for a large plan regardless of the number of late annual reports filed for the plan at the same time. There is no per-administrator or per-sponsor cap. If the same party is the administrator or sponsor of several plans required to file annual reports under Title I of ERISA, the maximum applicable penalty amounts would apply for each plan.

.91 *Small Plans Sponsored by Certain Tax-Exempt Organizations.* A special per-plan cap of \$750 applies to a small plan sponsored by an organization that is tax-exempt under Internal Revenue Code section 501(c)(3). The \$750 limitation applies regardless of the number of late annual reports filed for the plan at the same time. It is not available, however, if as of the date the plan files under the DFVC program, there is a delinquent annual report for a plan year during which the plan was a large plan.

.92 Top Hat Plans and Apprenticeship and Training Plans. The penalty amount for top-hat plans and apprenticeship and training plans was reduced to \$750.

Updated and Simplified Procedures

.93 The DOL also simplified and updated the procedures governing participation in the program. The changes are intended to make the program easier to use. For example:

- Plan administrators may use the Form 5500 forms for the year relief is sought or the most current form available at the time of participation. This option allows administrators to choose the form that is most efficient and least burdensome for their circumstances.
- The forms and penalty payment check should no longer be annotated in bold-red print identifying the filing as a DFVC filing.
- The program has been updated to conform to the annual reporting procedures under the computerized EFAST.
- The address where DFVC program remittances are submitted has been changed to DFVC Program, EBSA, P.O. Box 530292, Atlanta, Georgia 30353-0292. Submissions made to the old address will be returned to the filer.

IRS and PBGC Participation

.94 Although the DFVC program does not cover late filing penalties under the Internal Revenue Code or Title IV of ERISA, the IRS and PBGC agreed to provide certain penalty relief for delinquent Form 5500s filed for Title I plans where the conditions of the DFVC program have been satisfied.

Effective Date and Comments

.95 The modifications of the DFVC program were effective upon the March 28, 2002, publication in the *Federal Register* of a notice announcing the modifications.

.96 Questions about the DFVC program should be directed to EBSA by calling (202) 693-8360. For additional information about the Form 5500 Series, visit the EFAST Internet site at www.efast.dol.gov, or call the EBSA help desk toll free at (866) 463-3278.

DOL Issues Final Rules on Disclosure of Pension Plan “Blackout Periods”

.97 On January 24, 2003, the DOL published final rules implementing a new federal law requiring 401(k) plans to give workers 30-day advance notice of “blackout periods” when their rights to direct investments, take loans, or obtain distributions are suspended. These final rules supersede interim final rules issued by the department on October 21, 2002.

.98 Blackout periods typically occur when plans change recordkeepers or investment options, or add participants due to corporate merger or acquisition.

.99 On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002, giving the Secretary of Labor authority to promulgate rules and a model notice implementing the blackout notice provisions. The act requires that participants and beneficiaries be given a 30-day advance notice of a blackout period. When a blackout period affects a plan that includes employer stock as an investment option, the plan must also notify the corporate issuer of the employer stock, so corporate insiders are aware that they may not trade employer securities or exercise options during the blackout. The law is effective for blackout periods occurring on or after January 26, 2003.

.100 Under the final rules, 401(k) plan administrators must provide blackout notices that contain the reasons for the blackout, a description of the workers' rights that will be suspended, the start and end dates of the blackout period, and a statement advising workers to evaluate their current investments based on their inability to direct or diversify assets during the blackout period.

.101 Changes made to the interim final rules in the final regulations include:

- Flexibility for plan administrators in describing the starting and ending dates of the blackout period;
- Clarification of situations that are not blackout periods, such as suspensions resulting from pending qualified domestic relations order determinations and actions by individual participants; and
- A special rule for issuers of company stock who are also the plan administrators.

.102 Failure or refusal to provide the required notice may result in civil penalties. A second set of final rules issued by the DOL adopts the interim final rules that provide for civil penalties of up to \$100 per day per participant for plan administrators who fail or refuse to comply with the notice requirement.

.103 The rules may be viewed at www.dol.gov/ebsa under "Laws and Regulations."

The DOL Introduces New Compliance Assistance Tool—Field Assistance Bulletins

.104 On September 26, 2002, the DOL unveiled its first Field Assistance Bulletin (FAB) to publicize technical guidance provided to its field enforcement staff.

.105 In the course of audits and investigations by EBSA field enforcement staff, difficult legal issues often arise. In an effort to provide the regional office staff with prompt guidance, EBSA has developed a new vehicle for communicating technical guidance from the national office. FABs will ensure that the law is applied consistently across the various regions. They also will provide the regulated community with an important source of information about the agency's views on technical applications of ERISA. All FABs will be posted on EBSA's Web site and be available to the public.

.106 Secretary of Labor Elaine L. Chao has made compliance assistance a top DOL priority. The FABs are the next step in EBSA's continuing compliance assistance program to educate and assist employers, plan officials, service providers, and others in achieving and maintaining compliance with ERISA. These efforts include working to foster self-regulation and oversight by offering programs that encourage voluntary compliance, such as the VFPC and the DFVC program. EBSA's compliance assistance program also includes outreach, new educational materials, and a dedicated Web page. FABs, as well as future bulletins, will be available at www.dol.gov/ebsa under "Compliance Assistance" and "Laws and Regulations."

.107 The first FAB, Field Assistance Bulletin 2002-1, addresses the fiduciary considerations involved with the refinancing of an ESOP loan under ERISA section 408(b)(3).

.108 Field Assistance Bulletin 2002-2 addresses whether the trustees of two related multiemployer plans were subject to ERISA's fiduciary standards when they amended the plan's trust agreements.

.109 Field Assistance Bulletin 2002-3 addresses the fiduciary considerations regarding the use of agreements in which the service provider retains the "float" on plan assets.

Timeliness of Remittance of Participant Contributions Remains an Enforcement Initiative for the EBSA

.110 The EBSA 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. DOL regulations require 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 15 business days after the month in which the participant contribution was withheld or received by the employer.

.111 The regulation establishes a procedure by which an employer may obtain an extension of the 15-business-day limit for an additional 10 business days. This regulation does not change the maximum period for remittance of employee contributions to welfare plans as soon as practicable, but in no event more than 90 days after the day the contribution was withheld or received by the employer.

.112 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), regardless of materiality, 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 supplemental schedule, the auditor should (1) express a qualified opinion or an adverse opinion on the supplemental schedule if the transaction is material to the financial statements, or (2) modify his or her report on the supplemental schedule by adding a paragraph to disclose the omitted transaction if the transaction is not material to the financial statements. See Chapter 11, "Party in Interest Transactions," of the EBP Guide for further discussion of prohibited transactions.

Late Remittances

.113 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), regardless of materiality, and, in certain circumstances, may constitute embezzlement of plan assets. Such information should be reported on line 4a of either Schedule H or Schedule I of the Form 5500. Unless otherwise exempt, such transactions should also be reported on line 4d of either Schedule H or I; Part III of Schedule G (for large plans); and, if the plan is subject to the audit requirement, on the supplemental schedule of nonexempt transactions with parties in interest.

.114 Plan officials faced with remitting delinquent participant contributions should consider applying to the DOL's VFCP. Full compliance with the program will result in the DOL's issuance of a No-Action Letter and no imposition of penalties. In addition, applicants that satisfy both the VFCP requirements and the conditions of PTE 2002-51:

- Will be eligible for immediate relief from payment of certain prohibited transaction excise taxes imposed by the IRS. For more information, see 67 Federal Regulations 15062 and 67 Federal Regulations 70623 (November 25, 2002).
- Do not report the "corrected" transaction(s) as nonexempt transactions on line 4d of either Schedule H or Schedule I.
- Do not include such transaction(s) on the supplemental schedule of nonexempt transactions with parties in interest.

.115 The EBSA's Web site contains useful information about the VFCP and an FAQ section that addresses issues such as how lost earnings may be calculated on delinquently remitted employee contributions.

Help Desk—For further guidance visit the EBSA's Web site at www.dol.gov/ebsa, in the "Spotlight on . . ." section, and click on VFCP Fact Sheet & FAQs, or see the section "DOL Voluntary Fiduciary Correction Program" under "Other EBSA Matters You Should Be Aware of" in this Alert.

.116 It should be noted that the DOL's regional offices have conducted many investigations involving late remittances, often triggered by the reporting of late remittances on the plan's Schedule G attached to the Form 5500. It is not uncommon for the DOL to find additional late remittances that were not reported on the Schedule G once they begin their investigation. If a plan sponsor determines that they have late remittances, they should consider going back and reviewing all payroll remittances for the period under question to ensure they have a complete listing of all late remittances. The plan's auditor should also review the plan sponsor's procedures and consider additional testing, as applicable, to ensure completeness once it has been determined a late remittance has occurred since the auditor is opining on the schedule of nonexempt transactions.

Reporting Delinquent Participant Contributions on Schedule G

.117 Often there is confusion when reporting a late deposit of employee deferrals on Part III of Schedule G. As there are no precise instructions, consider completing the following items:

- The employer is generally considered the "party involved."
- The relationship is the "plan sponsor."
- The description is "loan to employer in the form of late deposits of employee 401(k) deferrals."
- The current value of asset is the amount of the lost interest.
- Other items should be left blank.

You may also wish to attach a statement to the Schedule G explaining the circumstances that led to the delinquent remittance(s), the steps taken to correct the situation, and an explanation about how lost earnings were calculated.

Help Desk—For questions or further information, contact the DOL Office of Regulations and Interpretations at (202) 693-8500.

Participant Loan Repayments Subject to Timing Rules

.118 In Advisory Opinion 2002-2A, the DOL concluded that, while not subject to the participant contribution regulation (29 C.F.R. §2510.3-102), participant loan repayments paid to or withheld by an employer for purposes of transmittal to an employee benefit plan are sufficiently similar to participant contributions to justify, in the absence of regulations providing otherwise, the application of principles similar to those underlying the final participant contribution regulation for purposes of determining when such repayments become assets of the plan. Specifically, the Advisory Opinion concluded that participant loan repayments paid to or withheld by an employer for purposes of transmittal to the plan become plan assets as of the earliest date on which such repayments can reasonably be segregated from the employer's general assets.

.119 Given the similar treatment of participant contributions and loan repayments, the DOL has determined that it is appropriate to permit delinquent participant loan repayments to be corrected under the VFCP in the same manner as delinquent participant contributions.

Help Desk—For questions or further information, contact the Office of Regulations and Interpretations at the DOL at (202) 693-8500.

Other EBSA Matters You Should Be Aware of

.120 This section discusses the following matters:

- 2002 Form M-1 Multiple Employer Welfare Arrangements
- DOL VFCP
- Direct Filing Entity (DFE) Enforcement Activities

2002 Form M-1 for Multiple Employer Welfare Arrangements

.121 On December 13, 2002, the DOL published in the *Federal Register* the Year 2002 Form M-1 annual report for multiple employer welfare arrangements (MEWAs). Although the format of the form has been improved to make it easier to read, the content is identical to the 2001 form.

.122 Generally, MEWAs are arrangements that offer medical benefits to the employees of two or more employers, or to their beneficiaries. These arrangements may not include plans that are established or maintained under collective bargaining agreements, by a rural electric cooperative, or by a rural telephone cooperative association.

.123 The DOL has authority under HIPAA to require reporting of information about MEWAs. Administrators generally must file the one-page Form M-1 annually. The year 2002 form is generally due March 1, 2003, but administrators may request an automatic 60-day extension to May 1, 2003.

.124 Administrators who fail to file the Form M-1, as required, are subject to penalties pursuant to DOL Regulation 29 CFR 2560.502c-5 of up to \$1,100 per day, continuing up to the date that the report is filed.

.125 The Year 2002 Form M-1 is available by calling EBSA's toll-free publications hotline at (800) 998-7542 and is available on the Internet at www.dol.gov/dol/ebsa. Administrators may contact the EBSA help desk for assistance in completing this form by calling (202) 693-8360.

DOL Voluntary Fiduciary Correction Program

.126 On March 15, 2000, the DOL adopted the VFCP, which helps plan officials quickly and completely correct certain employee benefit plan violations.

.127 The EBSA has authority to bring civil enforcement actions and assess monetary penalties for ERISA violations. The VFCP lays out procedures, the types of transactions covered by the program, and acceptable corrective actions that do not require consultation or negotiation with the department.

.128 Any plan official, sponsoring employer, or parties to affected transactions may apply to the appropriate EBSA regional office to voluntarily correct violations covered by the program. To qualify, applicants must have fully undone any prohibited transactions, restored any losses and profits with interest, and distributed any supplemental benefits owed to eligible participants and beneficiaries. In addition, a notice must be given to participants advising them of corrected violations.

.129 The transactions eligible (a total of 14 specific transactions) for the VFCP involve:

- Delinquent employee contributions
- Certain prohibited loans
- Loans with inadequate collateral or security
- Certain improper sales or purchases, including prohibited transactions
- Improper valuation of assets that affect benefit calculations
- Payment of excessive or duplicative fees

.130 Applicants who fully comply with all the terms and procedures of the VFCP will receive a No-Action Letter from EBSA and will not be subject to penalties. EBSA, however, does reserve the right to conduct investigations to determine truthfulness, completeness, and whether full correction was made.

.131 Applicants who fail to fully correct fiduciary violations will be rejected and become subject to enforcement action and civil penalties. In addition, persons involved in pending investigations or criminal violations cannot take advantage of the program.

.132 Information regarding the VFCP is available on the EBSA's Web site at www.dol.gov/dol/ebsa. Persons should telephone the EBSA regional office in their area with any questions about the application process. These telephone numbers may be found on the EBSA's Web site <http://askebsa.dol.gov>.

Direct Filing Entity Enforcement Activities

.133 During the second half of 2002, the DOL began a program to review the accuracy and completeness of Form 5500 filings made by direct filing entities (DFEs). Initial reviews of the 1999 Form 5500 database have identified numerous technical deficiencies in DFE filings—namely, not properly following the instructions. Several of the more common errors include:

- Incorrect completion of Schedule D, Part II, Information on Participating Plans (to be completed by DFEs). The schedule either:
 - Is not completed at all;
 - Fails to provide all of the participating plans employer identification numbers *and* three-digit plan numbers; or
 - Discloses participating plan information on an attachment in place of completing the schedule.
- The failure of DFE investment information on Schedule H, Part I, to reconcile with Schedule D, Part I.
- DFEs completing items on Schedule H that relate only to plan filings.

Enforcement letters have been sent to DFE filers requesting that the filings be corrected. Failure to correct the DFE filing may subject the participating plans' filings to rejection and further enforcement action by the EBSA.

.134 DFE filers are encouraged to carefully read and follow the directions contained in the Form 5500 instructions regarding completion of the necessary schedules and information. Questions concerning completion of the Form 5500 may be directed to the EBSA help desk toll free at (866) 463-3278.

Audit Issues

Consideration of Fraud in Employee Benefit Plan Engagements

.135 SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. SAS No. 99 supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316A), and amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230). SAS No. 99 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02). (SAS No. 99 also amends SAS No. 85, *Management Representations* [AICPA, *Professional Standards*, vol. 1, AU sec. 333].) SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002, with early application of the provisions permissible.

.136 There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting.
- Misstatements arising from misappropriation of assets.

.137 Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

The Importance of Exercising Professional Skepticism

.138 Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

.139 Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of SAS No. 99 (AU sec. 316.14–.18). The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (1) create incentives/pressures for management and others to commit fraud, (2) provide the opportunity for fraud to be perpetrated, and (3) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit. Examples of risk factors specific to employee benefit plans can be found in Appendix E of this Alert.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

.140 SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311.06–.08), provides guidance about how the auditor obtains knowledge about the entity's business and the industry in which it operates. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in SAS No. 99 [AU sec. 316.35–.42]) to identify the risks of material misstatement due to fraud:

1. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed. (See SAS No. 99 [AU sec. 316.20–.27].)
2. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See SAS No. 99 [AU sec. 316.28–.30].)
3. Consider whether one or more fraud risk factors exist. (See SAS No. 99 [AU sec. 316.31–.33], and the Appendix to SAS No. 99 [AU sec. 316.85])
4. Consider other information that may be helpful in the identification of risks of material misstatements due to fraud. (See SAS No. 99 [AU sec. 316.34].)

.141 In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting, for example, for employee benefit plans investment returns that vary from industry benchmarks for the investment type.

.142 *Considering Fraud Risk Factors.* As previously indicated, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as “fraud risk factors.” Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

.143 SAS No. 99 provides fraud risk factor examples that have been written to apply to most enterprises. Appendix E of the Alert contains a list of fraud risk factors specific to employee benefit plans.¹ Remember, fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

Identifying Risks That May Result in a Material Misstatement Due to Fraud

.144 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of SAS No. 99 (AU sec. 316.19–.34). The auditor’s identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management.

.145 For employee benefit plans, such accounts include valuation of nonmarketable investments; for pension plans the accumulated plan benefit obligation; for health and welfare plans the benefit obligations, including those for postretirement, postemployment, claims incurred but not reported, and claims payable. For multiemployer plans, estimates also include the amount and collectability of contributions receivable and withdrawal liabilities.

A Presumption That Improper Revenue Recognition Is a Fraud Risk

.146 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. (See SAS No. 99 [AU sec. 316.41].) For employee benefit plans, this risk is primarily related to investment income resulting from inappropriate investment valuation.

A Consideration of the Risk of Management Override of Controls

.147 Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see SAS No. 99 [AU sec. 316.57]) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in SAS No. 99 (AU sec. 316.58–.67) should be performed to further address the risk of management override of controls. These procedures include (1) examining journal entries and other adjustments for evidence of possible material misstatement

¹ (See also Appendix I of the EBP Guide for fraud risk factors specific to employee benefit plans.)

due to fraud, (2) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (3) evaluating the business rationale for significant unusual transactions.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

.148 Auditors should comply with the requirements of SAS No. 99 (AU sec. 316.43–.45) concerning an entity's programs and controls that address identified risks of material misstatement due to fraud.

.149 Examples of programs and controls for employee benefit plans include those examples detailed in Appendix B of the EBP Guide and also may include the following:

- Board of directors or committee oversight of the plan with qualified and stable members
- Identification and education of the individuals who have fiduciary responsibility for the plan
- Access to qualified ERISA counsel
- Use of reputable outside service providers, such as investment custodians, investment managers, recordkeepers, claims administrators, or paying agents
- Appropriate oversight and monitoring of outside service providers
- Plan administrator-maintained independent records; periodic checks of information provided to the investment custodian
- Preparation and review of reconciliations of trust assets to participant accounts or accounting records of the plan
- Segregation of duties related to benefit payments, contributions, investment transactions, and loans
- Process for approval of transactions with parties-in-interest
- Periodic "audit" of methodology and assumptions used in actuarial valuations
- In multiemployer plans, payroll audits of contributing employers to verify employer contributions receivable

.150 The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks, taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

Responding to the Results of the Assessment

.151 SAS No. 99 (AU sec. 316.46–.67) provides requirements and guidance about an auditor's response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

1. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned (see SAS No. 99 [AU sec. 316.50]).
2. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see SAS No. 99 [AU sec. 316.51–.56]).
3. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see SAS No. 99 [AU sec. 316.57–.67]).

.152 Appendix I, paragraph I.08 of the EBP Guide describes specific auditor procedures that could be performed for employee benefit plans.

Evaluating Audit Evidence

.153 SAS No. 99 (AU sec. 316.68–78) provides requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other evidential matter accumulated during the audit.

.154 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Responding to Misstatements That May Be the Result of Fraud

.155 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. See SAS No. 99 (AU sec. 316.75–78) for requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

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

1. Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.²
2. Consider the implications for other aspects of the audit (see SAS No. 99 [AU sec. 316.76]).
3. Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee.³
4. If appropriate, suggest that the client consult with legal counsel.

.157 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

² See Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), as amended, for guidance on auditors' reports issued in connection with audits of financial statements.

³ If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate.

Communicating About Possible Fraud to Management, the Audit Committee, and Others

.158 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See SAS No. 99 (AU sec. 316.82) for further requirements and guidance about communications with management, the audit committee, and others.

Documenting the Auditor's Consideration of Fraud

.159 SAS No. 99 (AU sec. 316.83) requires certain items and events to be documented by the auditor. Auditors should comply with those requirements.

Practical Guidance

.160 The AICPA Practice Aid *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide* (product no. 006613kk) provides a wealth of information and help on complying with the provisions of SAS No. 99. Moreover, this Practice Aid provides an understanding of the differences between the requirements of SAS No. 99 and SAS No. 82, which was superseded by SAS No. 99. This Practice Aid is an Other Auditing Publication as defined in SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

Limited-Scope Certifications

.161 The auditor may be engaged to perform a full-scope audit of the financial statements of an employee benefit plan in accordance with GAAS. Alternatively, ERISA section 103(a)(3)(c) allows the plan administrator to instruct the auditor not to perform any auditing procedures with respect to investment information prepared and certified by a bank or similar institution or by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency who acts as trustee or custodian. The election is available, however, only if the trustee or custodian certifies both the *accuracy and completeness* of the information submitted. Certifications that address only accuracy *or* completeness, but not both, do not comply with the DOL's regulation, and therefore are not adequate to allow plan administrators to limit the scope of the audit. This *limited-scope* audit provision does not apply to information about investments held by a broker/dealer or an investment company. However, some broker/dealers and investment companies have established separate trust companies that will provide a limited scope certification. The DOL has noted instances where limited scope audits were performed when the financial institution did not qualify.

.162 The auditor should note that certifications received from third-party administrators or service organizations may not qualify for the limited scope audit. In addition, if a limited-scope audit is to be performed on a plan funded under a master trust arrangement or other similar vehicle, separate individual plan certifications from the trustee or the custodian should be obtained for the allocation of the assets and the related income activity to the specific plan. The exemption applies only to the *investment* information certified by the qualified trustee or custodian, and does not extend to participant allocations, contributions, benefit payments, or other information, whether or not it is certified by the trustee or custodian. Thus, except for the investment-related functions performed by the trustee/custodian, an auditor conducting a limited-scope audit would need to include in the scope of the audit functions performed by the plan sponsor or other third-party service organizations, such as third-party welfare plan claims administrators or third-party savings plan administrators, if circumstances necessitate. The nature and scope of testing will depend on a variety of factors, including the nature of the functions being performed by the third-party service organization, whether a SAS No. 70 report that addresses areas other than investments is available, if deemed necessary, and, if so, the type of report and the related results. (See chapter 6 of the EBP Guide for a discussion of SAS No. 70.) The limited-scope audit exemption is implemented by 29 CFR 2520.103-8 of the DOL's Rules and Regulations for Reporting and Disclosure under ERISA. The limited-scope exemption does not exempt the plan from the requirement to have an audit. Guidance on the auditor's report and responsibilities for this type of limited-scope audit is provided in paragraphs 7.61 and 13.25 through 13.29. Exhibit 5-1 in chapter 5 of the EBP Guide summarizes the conditions that generally allow for limited-scope audits in decision tree format.

Self-Directed Investments—The DOL's Alternative Method of Reporting Participant-Directed Brokerage Window Investments

.163 Plan sponsors of participant-directed defined contribution plans continue to allow participants to expand their control over investment decisions, through self-directed investments,⁴ sometimes referred to as self-directed brokerage accounts. These features allow participants to select any investment they choose without oversight from the plan administrator or investment committee. The only limitation is the availability of the desired investment through the plan's service provider, which generally is a securities broker-dealer or is a broker-dealer that has an alliance with the plan's service provider. The self-directed feature is often in addition to a more traditional array of risk diverse mutual funds and other investment option choices. Often plan sponsors may charge participants' fees to provide this investment feature and may also require a minimum balance to be invested.

.164 While self-directed accounts should be viewed as individual investments for auditing and reporting purposes, the instructions to Form 5500, Schedule H, "Financial Information," permit aggregate reporting of certain self-directed accounts (also known as participant-directed brokerage accounts) on the Form 5500 and related schedule of assets.

.165 For Form 5500 reporting, investments made through participant-directed brokerage accounts may be reported as a single line item on the Schedule H of the Annual Return/Report Form 5500 rather than by type of asset on the appropriate line item for the asset category (in Parts I and II of Schedule H), for example, common stocks and mutual funds, provided the assets are *not*:

- Loans
- Partnership or joint-venture interests
- Real property
- Employer securities
- Investments that could result in a loss in excess of the account balance of the participant or beneficiary who directed the transaction

.166 This Form 5500 reporting creates an issue with investment reporting in plan financial statements because GAAP requires certain reporting and disclosures. The following table summarizes the differences between the Form 5500 alternative reporting for participant-directed brokerage account investments and GAAP that may raise issues for auditors when obtaining brokerage window investment information.

<i>Form 5500—Alternative Reporting</i>	<i>GAAP—Required Reporting and Disclosures</i>
<ul style="list-style-type: none"> • Certain investments and related income (see above) made through participant-directed brokerage accounts may be shown as single line items on Schedule H. • Certain investments listed on the Schedule of Assets (Held at End of Year) may be shown as a single line item. 	<ul style="list-style-type: none"> • Identification of investments representing 5 percent or more of plan net assets in the plan's footnotes. (See paragraph 3.28g of the EBP Guide.) • Reporting of investment income, exclusive of changes in fair value, in the statement of changes in net assets or the footnotes. (See paragraph 3.28b of the EBP Guide.) • Reporting of net appreciation/depreciation by investment type in the plan's footnotes. (See paragraph 3.25a of the EBP Guide.)

⁴ This is different from participant-directed investment fund options. Participant-directed investment fund options allow the participant to select from among various available alternatives and to periodically change that selection. The alternatives are usually fund vehicles, such as registered investment companies (that is, mutual funds); commingled funds of banks; or insurance company pooled separate accounts providing varying kinds of investments, for example, equity funds and fixed income funds.

.167 In addition, plan auditors may experience difficulty in obtaining brokerage window investment information by individual investment categories (such as common stocks and mutual funds) and brokerage window investment income (such as net appreciation/depreciation by type) from plan service providers. In plans subject to the limited scope audit provisions of ERISA, the investment certification may provide investment amounts only in total, not for the individual investments. However, brokerage window investments are not considered a fund or a pooled separate account subject to other reporting requirements. Individual investment information is needed by plan administrators and auditors for the valuation of investment assets in the plan and for audit testing and disclosure purposes in accordance with GAAP and GAAS. Therefore, it is important for plan administrators, recordkeepers, and service providers to maintain these records for audit and financial reporting purposes.

.168 It is also important to note that the single line reporting of participant-directed brokerage window investment assets on the Form 5500 is allowed provided the investment assets are not loans, partnership or joint-venture interests, real property, employer securities, or investments that could result in a loss in excess of the account balance of the participant or beneficiary who directed the transaction.

.169 This alternative method of reporting participant-directed brokerage window investments does not relieve fiduciaries from their obligation to prudently select and monitor designated plan investment options and brokers.

What Are Derivatives? How Do I Audit Them?

.170 As plan investments continue to lose value, many plan sponsors are turning to derivatives as tools to manage the risk stemming from fluctuations in foreign currencies, interest rates, and other market risks, or as speculative investment vehicles to enhance earnings. Derivatives get their name because they derive their value from movements in an underlying⁵ such as changes in the price of a security or a commodity. Examples of common derivatives are options, forwards, futures, and swaps. Employee benefit plans that use derivatives to manage risk are involved in hedging activities. Hedging is a risk alteration activity that attempts to protect the employee benefit plan against the risk of adverse changes in the fair values or cash flows of assets, liabilities, or future transactions. SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides guidance on auditing investments in debt and equity securities; investments accounted for under Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*; and derivative instruments and hedging activities. Paragraph 7.53 of the EBP Guide discusses the objectives of auditing procedures applied to derivative instruments and related transactions. Paragraph 7.54 discusses the auditing procedures to be applied to derivative instruments and hedging activities.

.171 The unique characteristics of derivatives instruments and securities, coupled with the relative complexity of the related accounting guidance, may require auditors to obtain special skills or knowledge to plan and perform auditing procedures. SAS No. 92 is intended to alert auditors to the possible need for such skill or knowledge. Also, see the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, for further guidance on auditing such instruments (product no. 012520).

Help Desk—Chapter 3 of the AICPA Audit and Accounting Guide *Audits of Investment Companies*, includes brief descriptions of certain financial instruments that may be helpful when such investments are used by employee benefit plans. Some derivative financial instruments commonly found in employee benefit plans include call options, forward foreign exchange contracts, futures contracts, put options, and synthetic guaranteed investment contracts (GICs). (For more information regarding current accounting and financial reporting for synthetic GICs, see paragraphs 7.44 and 7.45 of the EBP Guide.)

⁵ Paragraph 2.09 of the Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, defines an underlying as a specific interest rate, security price, commodity price, foreign exchange rate, index of prices, or rates, or other variable. An underlying may be a price or rate of an asset or liability, but it is not the asset or liability itself.

Health and Welfare Benefit Plan Issues—Confidentiality, Indemnification, and Business Associates Agreements

.172 In response to the new HIPAA regulations (see the section “The Health Insurance Portability and Accountability Act” in this Alert), claim processors may be updating and instituting a variety of confidentiality, indemnification, or business associates agreements to protect the organization when third parties request claim information. Many third-party administrators that process health and welfare claims for plan administrators do not have a report on their internal control prepared in accordance with SAS No. 70, as amended. It may be necessary for the auditor to request access to the third-party administrator’s records to test claim transactions in order to obtain sufficient evidence to achieve the audit objectives. In many instances, a third-party administrator will request that the auditor enter into a confidentiality, indemnification, or business associates agreement signed by the auditor, third-party administrator, and plan sponsor relating to the claims testing.

.173 Auditors need to take special care in reviewing these agreements. Often the auditor may not agree with certain language in the agreement, resulting in delays in the audit while mutually agreeable language is determined. Many of the representations are very broad. The agreements generally require that the auditor hold the claim processor harmless from any actual or threatened action arising from the release of information without limitation of liability. In addition, the agreements may require the auditor to hold the client harmless as well. This last indemnification will most likely contradict provisions in the engagement letter between the auditor and the client. Auditors need to keep in mind that the testing of claims at a third-party administrator could be delayed as a result of the request to sign such an agreement and should plan the timing of the audit accordingly. Before entering into any confidentiality agreements, the agreement should be reviewed by the auditor’s legal counsel. If the auditor is unable to obtain access to records as a result of not signing a confidentiality agreement, a scope limitation could result.

AICPA Peer Review Developments—Recurring Deficiencies Found in Employee Benefit Plan Audits and Commonly Overlooked Audit Areas

.174 The AICPA, working with EBSA, 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 Board⁶ in its review of employee benefit plans include:

- Inadequate testing of participant data
- Inadequate testing of investments, particularly when held by outside parties
- Inadequate disclosures related to participant-directed investment programs
- Failure to understand testing requirements on a limited-scope engagement
- Inadequate consideration of prohibited transactions
- Incomplete description of the plan and its provisions
- Inadequate or missing disclosures related to investments
- Failure to properly report on a DOL limited-scope audit
- Improper use of limited scope exemption because the financial institution did not qualify for such an exemption

⁶ Taken from the AICPA 2001/2002 Peer Review Board Oversight Task Force Report and Comments

- Inadequate or missing disclosures related to participant data
- Failure to properly report on and/or include the required supplemental schedules relating to ERISA and the DOL

.175 The EBP Guide provides guidance concerning areas where the Peer Review Board noted deficiencies.

Commonly Overlooked Audit Areas

.176 Specific areas often overlooked in employee benefit plan audits include the following.

.177 ***Eligible Compensation.*** Plan documents specify the various aspects of compensation (for example, base wages, overtime, and bonuses) that are considered in the calculation of plan contributions for defined contribution plans and in the determination of benefits in a defined benefit plan. Testing of payroll data should address the determination of eligible compensation for individual employees and comparison of the definition of eligible compensation used in the calculation to the plan document. Since this process is generally not included in the payroll testing of the plan sponsor or in Type II SAS No. 70 reports, a comparison of eligible compensation per the plan document to eligible compensation used in plan operations is required.

.178 ***Payroll Data.*** Reliance is often placed on testing of payroll performed in conjunction with a corporate audit; however, these procedures, which generally include only high level analytics with limited or no documentation of the control environment or performance of substantive procedures, are not sufficient in scope to opine on the benefit plan. Often payroll processing is outsourced to an outside service provider that may have a SAS No. 70 Type I report, which provides a description of procedures and controls, but does not have a SAS No. 70 Type II report, which also includes testing of the procedures and controls, and can be used to reduce the scope of substantive testing. Paragraph 10.05 of the EBP Guide describes procedures the auditor should consider to test payroll in conjunction with the plan audit.

.179 ***Service Organizations and SAS No. 70 Reports.*** Most employee benefit plans use service organizations (for example, bank trustees, insurance companies, or benefits administrators) to process transactions and maintain plan records. Often SAS No. 70 Type II reports are obtained and used by the auditor to reduce the amount of substantive testing required. Auditors often do not perform or document their evaluations of the extent of the evidence provided by the report regarding the effectiveness of controls for particular financial statement assertions and of its effect on audit strategy, including determination of the nature, timing, and extent of substantive tests for particular audit objectives. An evaluation of user organization controls that are contemplated in the design of the service organization's controls and recommended in the service organization's description of controls in the SAS No. 70 report should also be performed.

.180 For service organizations that do not issue a current Type II SAS No. 70 report, the working papers should contain sufficient documentation of the auditor's understanding of the control environment at the service organization and the results of the auditor's evaluation of the effectiveness of control policies and procedures sufficient to support the planned reliance approach. See chapter 6 of the EBP Guide for further discussion of internal controls.

.181 ***Understanding Investments.*** Plan investments represent the majority of assets held by a benefit plan. Benefit plans invest in a wide variety of investments and investment vehicles, some of which are not easily identified by review of the investment firms. It is important for auditors to gain an understanding of the types of investments the plan holds to determine the proper auditing procedures and accounting and reporting implications. This understanding can be obtained through (1) discussions with plan management, investment advisers, or custodian/trustees and (2) review of investment agreements, minutes of investment committee meetings, and other documentation. Chapter 7 of the EBP Guide provides a description of various investments and related audit procedures.

.182 Limited Versus Full-Scope Audits. Under DOL regulations, certain assets held by a bank, trust company, or similar institution or by a regulated insurance company and related investment information do not have to be audited provided the institution certifies the information. All noninvestment activity of the plan such as participant allocations, contributions, benefit payments, and expenses are subject to audit. See EBP Guide paragraphs 7.61 and 13.26 for limited scope procedures and reporting.

.183 Allocation Testing for Defined Contribution Plans. One of the objectives of auditing procedures applied to individual participant accounts of a defined contribution plan is to provide the auditor with a reasonable basis for concluding whether net assets and transactions have been properly allocated to participant accounts in accordance with the plan documents. Each type of participant account activity during the year (for example, contributions, income allocations, expenses allocations, and forfeiture allocations) should be taken into consideration in the determination of auditing procedures. In a limited scope audit, the allocation of investment income to individual accounts is not certified by the trustee/custodian and must be tested by the auditor, taking into consideration reliance on a SAS No. 70 Type II report, if available. See chapter 10 of the EBP Guide for further discussion of auditing participant data.

New Auditing, Attestation, and Other Guidance

.184 Presented below is a list of auditing, attestation, and quality control pronouncements, guides, and other guidance issued since the publication of last year's Alert.

Help Desk—For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i>
SAS No. 100	<i>Interim Financial Information</i>
SAS No. 101	<i>Auditing Fair Value Measurements and Disclosures</i>
SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i>
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i>
Amendment to Auditing Interpretation No. 2 of SAS No. 31	"The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals"
Auditing Interpretation No. 12 of SAS No. 1	"The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Changes in the Year of Adoption"
Auditing Interpretation No. 15 of SAS No. 58	"Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations"

Auditing Interpretation No. 16 of SAS No. 58	<i>"Effect on Auditor's Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940"</i>
Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Practice Alert No. 02-2	<i>Use of Specialists</i>
Practice Alert No. 02-3	<i>Reauditing Financial Statements</i>
Practice Aid	<i>Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide</i>
Practice Aid	<i>New Standards, New Services: Implementing the Attestation Standards</i>
Practice Aid	<i>Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users</i>

.185 The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 97, *Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles*

.186 SAS No. 97, *Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 625), revises SAS No. 50, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 625), to prohibit an accountant from providing a written report on the application of accounting principles not involving facts and circumstances of a specific entity.

.187 This Statement is effective for written reports issued or oral advice provided on or after June 30, 2002. Earlier application of the provisions of this Statement is permissible.

SAS No. 98, *Omnibus Statement on Auditing Standards—2002*

.188 In September 2002, the ASB issued SAS No. 98, *Omnibus Statement on Auditing Standards—2002*, which makes various amendments to existing SASs, including SAS No. 95 (AICPA, *Professional Standards*, vol. 1, AU sec. 150); SAS No. 25, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 161.02 and .03); SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312); SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324); SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.65); SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550); SAS No. 52, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558); and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551).

SAS No. 101, *Auditing Fair Value Measurements and Disclosures*

.189 This Statement establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements. In particular, the Statement addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. This Statement is effective for audits of financial statements for periods beginning on or after June 15, 2003, with earlier application permitted.

Accounting Developments

FASB Issues Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

.190 In April 2003, the FASB issued FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. The Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under FASB Statement No. 133. In particular, FASB Statement No. 149 amends FASB Statement No. 133 to say the following:

Certain investment contracts. A contract that is accounted for under either paragraph 4 of FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*, or paragraph 12 of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended by Statement 110, is not subject to this Statement. Similarly, a contract that is accounted for under either paragraph 4 or paragraph 5 of AICPA Statement of Position 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, is not subject to this Statement. Those exceptions apply only to the party that accounts for the contract under Statement 35, Statement 110, or SOP 94-4.

FASB Statement No. 149 is effective for contracts entered into or modified after June 30, 2003, with certain exceptions as described in FASB Statement No. 149, and for hedging relationships designated after June 30, 2003. The guidance should be applied prospectively.

.191 Since the issuance of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, questions were raised regarding the proper accounting for such contracts as insurance contracts, GICs, and synthetic GICs that are held by various defined contribution pension and health and welfare plans.

.192 FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*, amends FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, to require defined benefit plans to report insurance contracts “in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA” (that is, at either fair value or contract value). SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, indicates that a fully benefit-responsive investment contract should be reported at contract value and provides an example of a fully benefit-responsive synthetic GIC as an investment contract that is subject to SOP 94-4.

.193 A conflict with FASB Statement No. 133 arose because for some insurance contracts with embedded derivatives, FASB Statement No. 133 required that the insurance contract be bifurcated and the embedded derivative be accounted for separately (that is, at fair value). In addition, FASB Statement No. 133 Implementation Issue No. A16, “Synthetic Guaranteed Investment Contracts,” concluded that synthetic GICs met FASB Statement No. 133’s definition of a *derivative instrument* from the perspective of the issuer. Since FASB Statement No. 133’s definition applied to the terms of the contract, that conclusion also implied that synthetic GICs met the definition of a derivative from the viewpoint of the holder. A conflict arose because FASB Statement No. 133 did not contain an exception for synthetic GICs held by reporting entities subject to SOP 94-4 until now.

Accounting Trends & Techniques—Employee Benefit Plans

.194 *Accounting Trends & Techniques—Employee Benefit Plans* is a new publication intended to provide preparers and auditors of employee benefit plan financial statements with a compilation of illustrative financial statement disclosures and illustrative auditor’s reports based on examples from actual financial statements of all types of audited employee benefit plans. In addition, the publication contains an entire chapter illustrating management letters and common management letter comments found on actual plan audits.

Help Desk—To order this publication, call the AICPA Member Satisfaction Center at (888) 777-7077 and ask for product no. 006611kk.

New Accounting Pronouncements and Other Guidance

.195 Presented here is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert.

Help Desk—For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated with Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions—an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9</i>
FASB Statement No. 148	<i>Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123</i>
FASB Statement No. 149	<i>Amendment of Statement 133 on Derivative Instruments and Hedging Activities</i>
FASB Statement No. 150	<i>Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity</i>
FASB Interpretation No. 45	<i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i>
FASB Interpretation No. 46	<i>Consolidation of Variable Interest Entities</i>
SOP 01-5	<i>Amendment to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</i>
SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i>
SOP 02-2	<i>Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator</i>
Technical Practice Aids	<i>Software Revenue Recognition</i>
Questions & Answers	<i>FASB Statement No. 87, Employers' Accounting for Pensions</i>

.196 For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org.

Audit and Accounting Guide Revisions as of March 1, 2003

.197 The following list summarizes some of the revisions that will be included in the EBP Guide, with conforming changes as of March 1, 2003.

.198 The EBP Guide has been updated to reflect the issuance of the following pronouncements:

- FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*
- SAS No. 98, *Omnibus Statement on Auditing Standards—2002*
- SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*

.199 The EBP Guide also provides guidance on confidentiality, indemnity, and business associates agreements, and includes a revised Appendix I to reflect the issuance of SAS No. 99.

Help Desk—To order the EBP Guide, call the Member Satisfaction Center at (888) 777-7077 or go to CPA2Biz.com and order product no. 012593kk.

AICPA Professional Ethics Division Interpretations and Rulings

.200 Ethics Interpretations and rulings are promulgated by the executive committee of the Professional Ethics Division of the AICPA to provide guidelines on the scope and application of ethics rules but are not intended to limit such scope or application. Publication of an Interpretation or ethics ruling in the *Journal of Accountancy* constitutes notice to members. A member who departs from Interpretations or rulings shall have the burden of justifying such departure in any disciplinary hearing.

Help Desk—It is important for you to monitor the activities of the Professional Ethics Executive Committee because it may issue Interpretations, ethics rulings, or both, that may be relevant to your engagements. For full information about Interpretations and rulings, visit the Professional Ethics Team Web page at www.aicpa.org/members/div/ethics/index.htm. You can also call the Professional Ethics Team at (888) 777-7077, menu option 2, followed by menu option 2. It is important to point out that, for ERISA engagements, the DOL has separate independence standards that may be more restrictive than those of the AICPA. See *paragraph A.85* in Appendix A of the EBP Guide for a listing of the DOL's independence standards.

.201 This section of the Alert highlights some of the more important developments in the area of professional ethics and independence.

General Accounting Office Issues New Independence Rules

.202 In January 2002 the Government Accounting Office (GAO) amended *Government Auditing Standards* (GAS, also referred to as the Yellow Book), significantly tightening its auditor independence provisions. In issuing the new standard, the comptroller general stated that protecting the public interest and ensuring public confidence in the independence of auditors of government financial statements, programs, and operations, both in form and substance, were the overriding considerations. The updated standard is required reading for auditors of government entities and of organizations receiving government funds.

Help Desk—To help members and others better understand the new standard, the AICPA has developed two educational tools, which are available on the Institute's Web site (www.aicpa.org/members/div/ethics/index.htm): GAO independence standard and AICPA-GAO comparison of independence rules governing nonaudit services. In addition, the GAO issued a series of questions and answers relating to the standard (www.gao.gov/govaud/d02870g.pdf).

Recent Revisions to AICPA Ethics Interpretations and Rulings

.203 In March and April 2003 the Professional Ethics Executive Committee (PEEC) revised the following rulings and Interpretations of the AICPA Code of Professional Conduct (see the March 2003 issue of the *Journal of Accountancy* for the revisions):

- Revision of Interpretation No. 101-1, "Interpretation of Rule 101," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02)
- Revision of Interpretation No. 101-2, "Former Practitioners and Firm Independence" (ET sec. 101.04)

- Revision of Interpretation No. 101-10, "The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements" (ET sec. 101.12)
- Revision of Ethics Ruling No. 41, "Financial Services Company Client Has Custody of a Member's Assets," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.081-.082)
- Revision of Ethics Ruling No. 70, "Member's Depository Relationship With Client Financial Institution" (ET sec. 191.140-.141)
- Deletion of Ethics Ruling No. 77, "Individual Considering or Accepting Employment With the Client" (ET sec. 191.[154-.155])

.204 In July 2002, the PEEC revised the following rulings and Interpretations of the AICPA Code of Professional Conduct; see the July 2002 issue of the *Journal of Accountancy* for the revisions:

- Interpretation No. 101-1, "Interpretation of Rule 101," of ET sec. 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02)
- Ethics Ruling No. 10, "Member as Legislator," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.019-.020)

.205 In November 2002, the PEEC made certain revisions to the following ruling and Interpretation (see the November 2002 issue of the *Journal of Accountancy* for the revisions):

- Interpretation No. 101-5, "Loans From Financial Institution Clients and Related Terminology," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.07)
- Ethics Ruling No. 107, "Participation in Health and Welfare Plan Sponsored by Client," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.214-.215)

SEC Rules on Auditor Independence

.206 The SEC has approved rules on auditor independence and audit working paper retention to implement provisions of the Sarbanes-Oxley Act of 2002. The new independence rules require certain disclosures and reports by auditors and set conditions under which auditing firms would not be considered independent for purposes of performing audits of public company financial statements. The new rules address issues such as:

- Revising the rules related to the nonaudit services that, if provided to an audit client, would impair an accounting firm's independence
- Requiring that certain partners on the audit engagement team rotate after no more than five or seven consecutive years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempt from this requirement
- Establishing rules that an accounting firm would not be independent if certain members of management of that issuer had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures
- Establishing rules that an accountant would not be independent from an audit client if any "audit partner" received compensation based on the partner procuring engagements with that client for services other than audit, review, and attest services
- Requiring the auditor to report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer

- Requiring the issuer's audit committee to preapprove all audit and nonaudit services provided to the issuer by the auditor
- Requiring disclosures to investors of information related to audit and nonaudit services provided by, and fees paid to, the auditor

For further information about these new rules, visit AICPA Online at www.aicpa.org/sarbanes/secproposesrules.asp.

On the Horizon

.207 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented here is brief information about some ongoing projects that may be relevant to your engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.208 The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.com
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if available, your membership and subscriber number in the message.

Auditing Pipeline

Substantial Changes to Audit Process Proposed

.209 In December 2002, the AICPA's ASB issued an exposure draft proposing seven new SASs relating to the auditor's risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.

- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

.210 The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*
- *Audit Evidence*
- *Audit Risk and Materiality in Conducting an Audit*
- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39, Audit Sampling*

.211 The proposed SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit.

.212 The proposed SASs would be effective for audits of financial statements for periods beginning on or after December 15, 2004, to allow time for auditors to revise their methodologies and train their personnel to plan the initial application of these standards to their audits.

Accounting Pipeline

Exposure Draft on Loans and Certain Debt Securities Acquired in a Transfer (Formerly Known as Purchased Loans and Securities)

.213 AcSEC is issuing an exposure draft of a proposed SOP titled *Accounting for Loans and Certain Debt Securities Acquired in a Transfer*. This proposed SOP considers whether Practice Bulletin (PB) No. 6, *Amortization of Discounts on Certain Acquired Loans*, continues to be relevant given a number of FASB pronouncements issued subsequent to PB No. 6. The proposed SOP excludes originated loans from its scope. Readers should be alert to any final pronouncement.

Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment

.214 Proposed AICPA SOP *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, and proposed FASB Statement *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment—an amendment of APB Opinions No. 20 and 28 and FASB Statements No. 51 and 67 and a rescission of FASB Statement No. 73*, were issued simultaneously for public comment. Principally, the proposed FASB Statement would amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from its scope the accounting for acquisition, development, and construction costs of real estate developed and used by an entity for subsequent rental activities. The accounting for those costs would be subject to the guidance in the proposed SOP. It also would amend APB Opinion No. 28, *Interim Financial Reporting*, to require that those costs that the proposed SOP would require be expensed as incurred on an annual basis also be expensed as incurred in interim periods.

.215 The proposed SOP addresses accounting and disclosure issues related to determining which costs related to property, plant, and equipment should be capitalized as improvements and which should be charged to expense. The proposed SOP also addresses capitalization of indirect and overhead costs and component accounting for property, plant, and equipment. Final Statements are expected to be issued in 2003.

Exposure Draft—Omnibus Proposal of Professional Ethics Division Interpretations and Rulings

.216 The PEEC proposes revisions to Rule 101, *Independence*, for nonattest services, loans, and leases. One of the PEEC's primary responsibilities is to interpret the AICPA *Code of Professional Conduct* and amend it when necessary to ensure its continued effectiveness in protecting the public interest by promoting AICPA members' independence, integrity, and objectivity. In accordance with that responsibility, an exposure draft has been issued to solicit feedback on proposed independence rule revisions. For more information on this exposure draft, visit the Professional Ethics section of the AICPA Web site (www.aicpa.org).

International Accounting Standards

.217 The International Accounting Standards Committee (IASC) was formed in 1973 and is an independent, private sector body. The objective of the IASC is to harmonize the accounting principles for financial reporting around the world. The IASC publishes the International Accounting Standards.

Employee Benefit Plan-Related Standards

.218 The following are employee benefit plan-related standards:

- International Accounting Standard (IAS) No. 19, *Employee Benefits* (AICPA, *Professional Standards*, vol. 2, AC sec. 9019), addresses postemployment benefits including pensions.
- IAS No. 26, *Accounting and Reporting by Retirement Benefit Plans* (AICPA, *Professional Standards*, vol. 2, AC sec. 9026), addresses the accounting and reporting by retirement benefit plans. It establishes separate standards for reporting by defined benefit plans and by defined contribution plans.

.219 In June 2002 the IASB agreed to add a limited convergence project on postemployment benefits to its agenda. The purpose of this project is to build on the principles that are common to most existing national standards on postemployment benefits and to seek improvements to IAS No. 19 in certain specific areas.

Help Desk—For further information regarding the IASC and its standards visit its Web site at www.iasb.org.uk.

Resource Central

*Employee benefit plan-related educational courses,
Web sites, publications, and other resources available to CPAs*

Related Publications

.220 The following are some of the AICPA publications that deliver valuable guidance and practical assistance as potent tools to be used on your employee benefit plan engagements.

- AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, with conforming changes as of March 1, 2003 (product no. 012593kk).

- **New! Accounting Trends & Techniques—Employee Benefit Plans** (product no. 006611kk). Offering the same kind of powerful help that the AICPA's *Accounting Trends and Techniques* does, this comprehensive book illustrates a wide range of employee benefit plan financial statement disclosures and auditors' reports for both full-scope and limited-scope audits. The publication also includes a chapter dedicated to illustrative management letters and management letter comments.
- **AICPA Practice Aid Auditing Multiemployer Plans** (product no. 006603kk). This publication provides guidance on unique issues regarding the accounting, auditing, and reporting on financial statements of various types of multiemployer employee benefit plans. This nonauthoritative Practice Aid is designed to complement the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*. There are chapters on SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*; application; investments; employer payroll audits; internal control testing; and more. Also included are illustrative financial statements for various types of multiemployer employee benefit plans.
- **Checklists and Illustrative Financial Statements for:**
 - *Defined Benefit Pension Plans* (008776kk). The 2003 checklist will be available this summer (product no. 008789kk).
 - *Defined Contribution Pension Plans* (008777kk). The 2003 checklist will be available this summer (product no. 008790kk).
 - *Health and Welfare Benefit Plans* (008778kk). The 2003 checklist will be available this summer (product no. 008791kk).
- "A Wake-Up Call," an employee benefit plan audit video (013801kk).

AICPA's reSOURCE Online Accounting and Auditing Literature

.221 Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, *Audit and Accounting Guides* (all 23), *Audit Risk Alerts* (all 19), and *Accounting Trends & Techniques*. To subscribe to this essential service, go to CPA2biz.com.

reSOURCE CD-ROM

.222 The AICPA is currently offering a CD-ROM product entitled *reSOURCE: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access in Windows format to AICPA Professional Literature products, namely, *Professional Standards*, *Technical Practice Aids*, and *Audit and Accounting Guides* (available for purchase as a set that includes all Guides and the related *Audit 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.

Conferences

National Conference on Employee Benefit Plans

.223 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 2004 National Conference on Employee Benefit Plans will be held May 3–5, 2004, in Orlando, Florida. For a conference brochure, please call (888) 777-7077, and request brochure G50038; for more information, visit the Web site at www.cpa2biz.com/conferences.

Education Courses

.224 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working on employee benefit plan engagements. Those courses include:

- *Audits of Employee Benefit Plans*
- *Audits of 401(k) Plans*

Online CPE

.225 *AICPA InfoBytes*, offered exclusively through CPA2Biz, is AICPA's flagship online learning product. Selected as one of *Accounting Today's* top 100 products for 2003, *AICPA InfoBytes* now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay \$149 (\$369 nonmembers) for a new subscription and \$119 (\$319 nonmembers) for the annual renewal. Divided into one- to two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit <http://cpa2biz.com>.

CPE CD-ROM

.226 *The Practitioner's Update* (product no. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

.227 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.228 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.229 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.

Web Sites

AICPA Online and CPA2Biz

.230 AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, CPA2Biz.com offers all the latest AICPA products, including Audit Risk Alerts, *Audit and Accounting Guides*, *Professional Standards*, and CPE courses.

Other Helpful Web Sites

.231 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of this Alert.

.232 This Audit Risk Alert replaces *Employee Benefit Plans Industry Developments—2002*.

.233 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 Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be greatly appreciated. You may e-mail these comments to ldelahanty@aicpa.org or write to:

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Information Sources

<i>Organization</i>	<i>General Information</i>	<i>Fax Services</i>	<i>Web Site Address</i>
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
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
<i>Department of Labor:</i> Pension and Welfare Benefits Administration: Office of the Chief Accountant: Division of Accounting Services Division of Reporting Compliance Office of Regulations and Interpretations	 (202) 693-8360 ERISA related accounting and auditing questions (202) 693-8360 Form 5500 preparation and filing requirements (202) 693-8360 (202) 693-8500		www.dol.gov/dol/ EBSA

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Appendix A

IRS Limits on Benefits and Compensation

	2003	2002	2001
Defined benefit			
Maximum annual pension	\$160,000	\$160,000	\$140,000
Defined contribution			
Maximum annual addition	\$ 40,000	\$40,000 ¹	\$ 35,000
401(k) plan			
Maximum elective deferral	\$ 12,000	\$11,000 ²	\$ 10,500
403(b) plan			
Maximum elective deferral	\$ 12,000	\$ 11,000	\$ 10,500
457 plans	\$ 12,000	\$ 11,000	\$ 8,500
SIMPLE plans	\$ 8,000	\$ 7,000	\$ 6,500
Qualified plans			
Maximum compensation limits	\$200,000	\$200,000	\$170,000
Highly compensated limits	\$ 90,000	\$ 90,000	\$ 85,000
Officer limits (key employee)	\$130,000	\$130,000	\$ 70,000
FICA taxable wage base	\$ 87,000	\$ 84,900	\$ 80,400
Employer and employee Social Security tax	6.20%	6.20%	6.20%

¹ The limitation for defined contribution plans is increased from \$35,000 to \$40,000 effective for limitation years beginning after December 31, 2001, and remained at \$40,000 for 2003.

² See Appendix C for a summary of major retirement plan law changes resulting from the Economic Growth and Tax Relief Reconciliation Act of 2001. These changes include catch-up contributions for individuals over age 50. The catch-up contribution increased from \$1,000 in 2002 to \$2,000 in 2003.

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Appendix B

Commonly Asked Questions and Answers

The following questions and answers have been developed by the members of the 2002 Employee Benefit Plans Audit Guide Revision Task Force. They include frequently asked questions encountered by the task force members on accounting, auditing, and regulatory matters.

- Q.** Can the plan sponsor accept a certification from the plan's recordkeeper if the recordkeeper certifies the investment information to be complete and accurate on behalf of the plan's trustee/custodian as "agent for"?
- A.** According to the U.S. Department of Labor (DOL), such a certification generally would be acceptable if there is in fact a legal arrangement between the trustee and the recordkeeper to be able to provide the certification on the trustee's behalf. Care should be taken by the plan administrator to obtain such legal documentation. Additionally the plan auditor might consider adding wording to the standard limited scope report to include reference to such an arrangement. Sample language might include the following: "any auditing procedures with respect to the information described in Note X, which was certified by ABC, Inc., the recordkeeper of the Plan as agent for XYZ Bank, the trustee of the Plan, . . . We have been informed by the plan administrator that the trustee holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the agent on behalf of the trustee, as of and for the year ended December 31, 20XX, that the information provided to the plan administrator by the agent for the trustee is complete and accurate." The third paragraph of the report should also be modified.
- Q.** Is it permissible to perform a limited scope audit on a portion of the plan's investments but not all (some investments did not meet the DOL 29 CFR 2520.103-8 criteria for a limited scope audit)? If yes, what form does the auditors' report take?
- A.** Yes, it is permissible to perform a limited scope audit on only a portion of a plan's investments and audit the remaining investments. The auditors' report is the same as that used for a limited scope audit. However, the note that is referenced in the auditor report should clearly identify the investments that were not audited.
- Q.** Under Form 5500 (Schedule H, Part IV, line 4j), there is a special rule whereby transactions under an individual account plan that a participant directs should not be taken into account for purposes of preparing the Schedule of Reportable Transactions. What about situations where an individual account plan is participant-directed but has certain transactions that appear to be nonparticipant-directed (for example, "pass through" account for contributions)?
- A.** If the plan is an individual account plan and the overall structure of the plan is participant-directed, "pass through" account transactions would not be required to be included on the Schedule of Reportable Transactions. Another example would be a participant-directed individual account plan that liquidates its investment options as a result of a plan termination, merger, or change in service provider. Often such changes result in the plan sponsor directing the plan trustee to liquidate the current balance in the participant-directed investment options into a short-term fund before the transfer to new investment options. Such transactions would not be required to be included on the Schedule of Reportable Transactions.
- Q.** What are the general conditions requiring an audit of pension plan financial statements?
- A.** An audit generally is required if the plan is covered under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) and there are over 100 participants as of the beginning of the plan year. Exhibit 5-2 in chapter 5 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, with conforming changes as of March 1, 2003 (the EBP Guide) provides guidance on determining

who is considered a participant. In addition, DOL regulations permit plans that have between 80 and 120 participants at the beginning of the plan year to complete the Form 5500 in the same category ("large plan" or "small plan") as was filed in the previous year.

- Q. What audit procedures should be performed on material plan mergers into a plan? What audit procedures are required when the prior plan was audited? What if the prior plan was never audited?
- A. If the prior plan was audited, the auditor should obtain the audited financial statements to ensure that the balance transferred from the prior plan financial statements reconciles to the balance that is reflected on the new plan's financial statements. Also, the auditor will generally perform procedures to ensure that a sample of participant accounts were properly set up under the new plan. In addition to the participant level testing, if the prior plan was not audited, the auditor will generally perform audit procedures to determine that the equity that is transferred from the prior plan is reasonable based upon an analysis of historical activity. (Other audit procedures relating to plan mergers can be found in paragraphs 12.13 through 12.16 of the EBP Guide.)
- Q. When a plan operates in a decentralized environment, what additional audit procedures should be considered?
- A. The auditor should consider the controls at each decentralized location as well as the overall mitigating controls that may be performed on a centralized basis. Taking into consideration the materiality of the activity at each decentralized location, the auditor may choose to expand participant level and substantive testing to incorporate these decentralized locations.
- Q. When the majority of a plan's assets are held in a master trust, but the plan has investments outside of the master trust, what are the requirements for the supplemental schedules?
- A. The Form 5500 instructions exclude master trust assets from the supplemental schedule reporting requirements. However, any assets held outside the master trust must be reported on the supplemental schedules. When calculating the 5 percent threshold for disclosing reportable transactions, the current value of master trust assets is subtracted from the beginning of the year net asset balance.
- Q. Is the master trust required to be audited?
- A. While the DOL does not require the master trust to be audited, the plan administrator normally engages an auditor to report only on the financial statements of the individual plans. If the master trust is not audited, the plan auditor should perform those procedures necessary to obtain sufficient audit evidence to support the financial statement assertions as to the plan's investments or qualify or disclaim his or her report.
- Q. Is a certification at the master trust level acceptable under DOL regulation 2520.103-8?
- A. If a limited scope audit is to be performed on a plan funded under a master trust arrangement or other similar vehicle, the DOL requires separate individual plan certifications from the trustee or the custodian regarding the allocation of the assets and the related income activity to the specific plan.
- Q. Should noninterest-bearing cash be included as an asset on the supplemental schedule of assets (held at end of year)?
- A. Generally, only assets held for investment are included on the supplemental schedule of assets (held at end of year); thus noninterest-bearing cash would not be included. Interest-bearing cash accounts would be included on the supplemental schedule.
- Q. Can immaterial investments be netted together as "other" on the supplemental schedule of assets (held at end of year)?
- A. No, each investment must be separately listed on the supplemental schedule.
- Q. What is the auditor's responsibility for detecting nonexempt transactions resulting from participant contributions that are not remitted to the plan within the guidelines established by DOL regulations?

- A. An audit performed in accordance with generally accepted auditing standards (GAAS) cannot be expected to provide assurance that all party-in-interest transactions will be discovered. Nevertheless, during the audit the auditor should be aware of the possible existence of party-in-interest transactions. During the planning phase of the audit, the auditor should inquire about the existence of any party-in-interest or nonexempt transactions. If any issues relating to late remittances are brought to the auditor's attention, the auditor may consider obtaining a schedule of employee contributions detailing payroll withholding date and date of deposit to the plan. A sample of deposits can then be traced to the supporting payroll register and wire transfer advice or check. Further, the auditor should have the client include in the management representation letter a representation that there are no party-in-interest transactions that have not been disclosed in the supplemental schedules.
- Q. If a nonexempt transaction related to the above is noted, is materiality of the transaction taken into consideration in determining the need for the supplemental schedule of nonexempt transactions?
- A. There is no materiality threshold for the inclusion on the supplemental schedule. All known events must be reported.
- Q. When is a plan subject to the requirements of the Securities and Exchange Act of 1933, thus requiring a Form 11-K filing under the Securities and Exchange Act of 1934?
- A. Section 3(a)(2) of the Securities and Exchange Act of 1933 provides exemptions from registration requirements for defined benefit plans and defined contribution plans not involving the purchase of employer securities with employee contributions. All other plans are subject to the requirements, provided they are both voluntary and contributory. (For further guidance, see paragraph 12.24 of the EBP Guide.) Advice of counsel should be obtained to determine if the registration requirements apply to the plan.
- Q. In a defined contribution plan, can investments be shown as a one-line item on the financial statements?
- A. Participant-directed plan investments may be shown in the aggregate, as a one-line item in the statement of net assets available for benefits. The presentation of nonparticipant-directed investments in the statement of net assets available for benefits or in the notes should be detailed by general type, such as registered investments companies, government securities, corporate bonds, common stocks, and so on.
- Q. If investments are shown as a one-line item in a defined contribution plan, what disclosures are required?
- A. The presentation should indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were determined otherwise. Investments that represent 5 percent or more of the net assets available for benefits should be separately identified. If any of those investments are nonparticipant-directed, they should be identified as such. Listing all investments in the schedule of assets (held at end of year) required by the ERISA does not eliminate the requirement to include this disclosure in the financial statements.
- Q. Are participant loans considered an investment on the face of the financial statements or as a loan receivable?
- A. Loans are considered an investment for reporting purposes.
- Q. Should the benefits paid per the statement of changes in net assets available for plan benefits agree to the benefits paid in the statement of changes in accumulated plan benefits for a defined benefit pension plan?
- A. The benefits paid should be the same on both statements. If differences are noted, the auditor should resolve the issue with the actuary to determine if the actuarial number requires adjustment.
- Q. Is the schedule of 5 percent reportable transactions required for defined benefit plans?

- A. As defined benefit plans generally are not participant-directed, the reportable transactions schedule would be required.
- Q. When does a health and welfare plan require an audit?
- A. A health and welfare plan is required to have an audit when the plan has more than 100 participants at the beginning of the plan year (this can be expanded to 120 if the 80-to-120-participant rule applies) and the plan is funded. According to DOL Regulation 2520.104-44, the existence of a separate fund or account for the plan by the employer or a third-party administrator (TPA) can cause the requirement that funds be paid directly from the general assets of the sponsor not to be met. For example, if a separate account is maintained that would be deemed to be a trust under state law, the related plan would be deemed to be funded under ERISA. It is not always easy to determine when a plan is considered funded. The auditor may wish to consult with legal counsel, plan actuaries, or the DOL to determine if a plan meets the definition of funded.
- Q. Are participants counted the same way for pension plans and health and welfare benefit plans?
- A. Participants for health and welfare plans are employees who are eligible and are receiving coverage under the plan.
- Q. If participants are contributing toward the health and welfare benefits, is an audit required?
- A. According to DOL Technical Releases 88-1 and 92-1, participant contributions to a welfare plan that has an Internal Revenue Code (IRC) section 125 cafeteria plan feature do not have to be held in trust. If contributions are not through a Section 125 plan and they are not used for the payment of insurance or health maintenance organization (HMO) premiums, generally, they will be required to be held in trust. If the plan is funded voluntarily or as required by DOL regulation, then the plan would require an audit.
- Q. If a plan offers several benefits under the plan document, and only medical is funded through the voluntary employees' beneficiary association (VEBA) trust, what is the audit requirement?
- A. The audit requirement is of the plan; not the trust. All benefits covered by the plan should be included in the audited financial statements.
- Q. If a VEBA trust is used as a pass-through for claims payment during the year, but there are no monies in the VEBA trust at year end, is an audit of the plan required?
- A. If a plan is deemed to be funded for a part of a plan year, the entire plan year is subject to the audit requirement. All plan activity for the entire year would have to be included in the audited financial statements.
- Q. If multiple plans use a VEBA trust, can an audit be performed at the VEBA trust level?
- A. The audit requirement is of the plan, not the trust. Each plan would require a separate audit if it individually met the audit requirement (see previous question). The auditor may be engaged to audit the VEBA trust in order to assist with the plan level allocation reporting, but this would not fulfill the plan level audit requirement.
- Q. Does the funding of a health and welfare benefit plan through a 401(h) account, when the plan was otherwise unfunded, cause the plan to require an audit?
- A. If the plan was otherwise unfunded, the 401(h) account association will not cause the health and welfare benefit plan to be considered funded for audit determination purposes.
- Q. What responsibility does the auditor have in testing plan qualification tests (for example, ACP and ADP) prepared by a client's third-party administrator?
- A. An audit in accordance with GAAS is not designed to ensure compliance with all legislative and regulatory provisions. However, Plans must be designed and comply with certain operating tests in order to maintain their qualified status. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible violations affecting the financial statements,

the auditor should apply auditing procedures specifically directed to ascertaining whether a violation has occurred. The auditor is also expected to inquire of, and obtain representation from, management concerning compliance with laws and regulations and the prevention of violations that may cause disqualification.

- Q. If the plan fails its 2000 discrimination test and has to return employee contributions in 2001 should "Excess Contribution Payable" liability be shown on the 2000 financial statement?
- A. Yes, the financial statements should reflect a liability for excess contributions payable on the financial statements if the amount is material to the financial statements.
- Q. What alternate audit procedures should be done to test participants' investment allocation of deferral contributions where no documentation exists (participants can change deferrals and allocation of such online or via phone)?
- A. Where participants make contributions or investment elections by telephone or electronic means (such as the Internet), consider confirming contribution percentage, source, and investment election directly with the participant or compare to a transaction report, if one is maintained. Alternatively, if the service provider has a Type II Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, report that provides evidence that the service auditor has tested investment allocations, the auditor may place some reliance on the SAS No. 70 report to reduce other testing.
- Q. For a DOL-limited scope audit, is it necessary to test the allocation of investment earnings at the participant account level?
- A. The testing of allocation of investment earnings at the participant level is part of the participant data testing and is required for a limited scope audit.
- Q. How should a late transmittal be handled in a multiemployer 401(k) plan audit where one of the participating employers submitted its cumulative contribution report containing late employee 401(k) contributions? What needs to be disclosed on the financial statement and Form 5500?
- A. The lost earnings due to the plan because of the late contribution should be shown on Form 5500 Schedule G, "Schedule of Nonexempt Transactions." The board of trustees should be made aware of the fact that there is a prohibited transaction that is required to be reported on the supplemental schedule of nonexempt transactions, which is part of the audited financial statements. The employer is responsible for depositing the lost earnings into the plan, filing the excise tax return, and paying the excise tax.
- Q. I understand that brokerage accounts can be listed on one line item on the Form 5500. Can they be listed on one line item on the supplemental schedules to the financial statements or do the individual underlying investments have to be listed?
- A. Individually directed brokerage accounts may be listed as one line item on the statement of net assets available for benefits and on the supplemental schedule of assets, provided the investments are not loans, partnerships or joint-venture interests, real property, employer securities, or investments that could result in a loss in excess of the account balance of the participant or beneficiary who directed the transaction. However, the notes to the financial statements must disclose any individual investment that is over 5 percent of net assets available for benefits at the end of the year. In addition, the investment income for individually directed brokerage accounts may be shown as one line item in the Form 5500; however, the financial statements must separate interest and dividends from net appreciation (depreciation) in fair value on the statement of changes in net assets available for benefits and disclose net appreciation (depreciation) by type of investment in the notes to the financial statements.

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Appendix C

Summary of Major Retirement Plan Law Changes

The following table summarizes the major retirement plan law changes resulting from the Economic Growth and Tax Relief Reconciliation Act of 2001.

<i>Summary of Major Retirement Plan Law Changes</i>				
<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
1	Increased IRA contribution limits IRC §219	The current \$2,000 contribution limit is increased for traditional and Roth IRAs to \$3,000 beginning in 2002, then to \$4,000 in 2005, and \$5,000 in 2008. After 2008, the limit will be adjusted for inflation.	2002	601
2	Catch-up IRA contributions for individuals over 50 IRC §219	Individuals who are at least age 50 by the end of the tax year can increase their normal IRA contribution limit by \$500 per year for 2002–2005 and \$1,000 for 2006 and later. Thus, for example, such an individual's total limit in 2002 will be \$3,500 (\$3,000 regular limit plus the special over 50 limit of \$500).	2002	601
3	Increased benefit and contribution limits for qualified plans IRC §§401(a)(17) and 415	<p>New law limits:</p> <ul style="list-style-type: none"> • Section 415(b)(1)(A) limit on annual benefits from a defined benefit plan will be \$160,000. • Section 415(c)(1) limit on annual additions to a defined contribution plan is raised from \$35,000 to \$40,000. • Section 401(a)(17) limit on compensation for plan purposes is raised from the current \$170,000 to \$200,000. <p>All three new limits will be indexed for inflation after July 1, 2001.</p>	<ul style="list-style-type: none"> • Years ending after 2001 • Years beginning after 2001 • Years beginning after 2001 	611
4	Elective deferrals IRC §402(g)	The current \$10,500 limit on elective deferrals is increased to \$11,000 in 2002 and then by \$1,000 each year until it reaches \$15,000 in 2006.	2002	611
5	Elective deferrals to SIMPLE plans IRC §408(p)(2)	The current \$6,500 SIMPLE retirement account limit is increased to \$7,000 in 2002 and then by \$1,000 each year until it reaches \$10,000 in 2005.	2002	611

(continued)

<i>Summary of Major Retirement Plan Law Changes</i>				
<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
6	Plan loans for owner employees IRC §4975(f)(6)	The special restrictions under current law on plan loans to owner employees is generally eliminated. This will allow for loans to sole proprietors, more-than-10% partners, and more-than-5% sub-S shareholders under the same rules as for other employees. Present law restrictions will continue to prohibit loans from IRAs, including SEPs and SIMPLE IRAs.	2002	612
7	Top-heavy provisions IRC § 416(i)	The top-heavy rules are changed: Three changes have been made to the definition of <i>key employee</i> : (1) The determination will be based solely on the participant's status and compensation in the plan year containing the determination date (the preceding 4 years will no longer be considered), (2) an officer is treated as a key employee based on officer status only if the employee earns more than \$130,000, and (3) the "top 10 owner" category has been eliminated. Matching contributions will now count toward satisfying the top-heavy minimums. The matching contribution of a safe harbor 401(k) plan will be deemed to satisfy the top-heavy rules. This does not mean that the match will automatically satisfy top-heavy rules for an accompanying profit-sharing plan, although the matching contributions will count toward otherwise satisfying the minimum. The 5-year look-back rule applicable to distributions will be shortened to one year for distributions other than in-service distributions. A frozen top-heavy defined benefit plan will no longer be required to make minimum accruals on behalf of non-key employees.	2002	613
8	Elective deferrals and employer deduction limits IRC § 404(n)	Elective deferrals will no longer be considered employer contributions for purposes of the IRC § 404 deduction limits.	2002	614

(continued)

<i>Summary of Major Retirement Plan Law Changes</i>				
<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
9	Deduction limit definition of compensation IRC § 404(a)(3)(A)	The definition of compensation for purpose of the deduction limit rules will include salary reduction amounts treated as compensation under IRC § 415 (e.g., 401(k) plan elective deferrals).	2002	616
10	Profit-sharing and stock bonus plan deduction limit increased IRC § 404(a)	The annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan is increased from 15% to 25% of compensation of the employees covered by the plan for the year. Also, except to the extent provided in regulations, a money purchase pension plan is treated like a profit-sharing or stock bonus plan for purpose of the deduction rules.	2002	616
11	Option to treat elective deferrals as Roth contributions IRC § 402A	Effective for tax years beginning after 2005, the Act allows participants in certain plans to make after tax deferrals treated as Roth contributions.	Effective for years beginning after 2005	617
12	Tax credit for contributions IRC § 25B	From 2002 through 2006, eligible taxpayers will receive a nonrefundable tax credit of up to 50% of contributions made to an IRA 401(k), 403(b), SIMPLE, SEP, or 457 plan. This credit is available on the first \$2,000 of contributions (reduced by certain distributions) and is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The amount of the credit is determined by the adjusted gross income (AGI). For a joint filer with an AGI between \$0-\$30,000, the credit rate is 50%. The rate decreases to 20% when the AGI exceeds \$30,000 and then to 10% when the AGI exceeds \$32,500; it finally phases out at AGI of \$50,000.	2002	618
13	Credit for new retirement plan expenses IRC § 45E	Effective for plans established after December 31, 2001, in tax years beginning after that date, the Act provides a nonrefundable income tax credit for the administrative and retirement-education expenses of a small business that adopts a new qualified defined benefit or defined contribution plan, a SIMPLE plan, or SEP. The credit applies to 50% of the first \$1,000 of qualified expenses for each of the first three years of the plan.	2002	619

(continued)

<i>Summary of Major Retirement Plan Law Changes</i>				
<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
		The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in excess of \$5,000. For an employer to be eligible for the credit, the plan must cover at least one non-highly compensated employee. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees who have been with the employer at least three months. The 50% of qualifying expenses offset by the credit are not deductible. However, the other 50% of such expenses (along with other expenses above the \$1,000 limit) are deductible to the extent permitted under present law.		
14	Catch-up contributions IRC § 414(v)	<p>A plan may allow individuals who have attained age 50 by year end to make catch-up contributions. The otherwise applicable dollar limit on elective deferrals under a Section 401(k) or Section 457 plan, Section 403(b) annuity, SEP, or SIMPLE is increased. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, they are not subject to applicable nondiscrimination rules. However, they must be available to all participants over age 50 on an equal basis.</p> <p>An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normally applicable rules.</p> <p>The allowable catch-up contribution applicable to 401(k), 403(b), SEP, and 457 for 2002 is \$1,000. This amount is increased by \$1,000 each year until it reaches \$5,000 in 2006.</p> <p>For SIMPLE IRA and 401(k) plans, the amount for 2002 is \$500 and is increased \$500 each year until it reaches \$2,500 in 2006.</p>	2002	631
15	Increased annual additions limit for defined contribution plans IRC § 415(c)(1)	The annual additions limit is increased from 25% of compensation under a defined contribution plan to 100% of compensation.	2002	632

(continued)

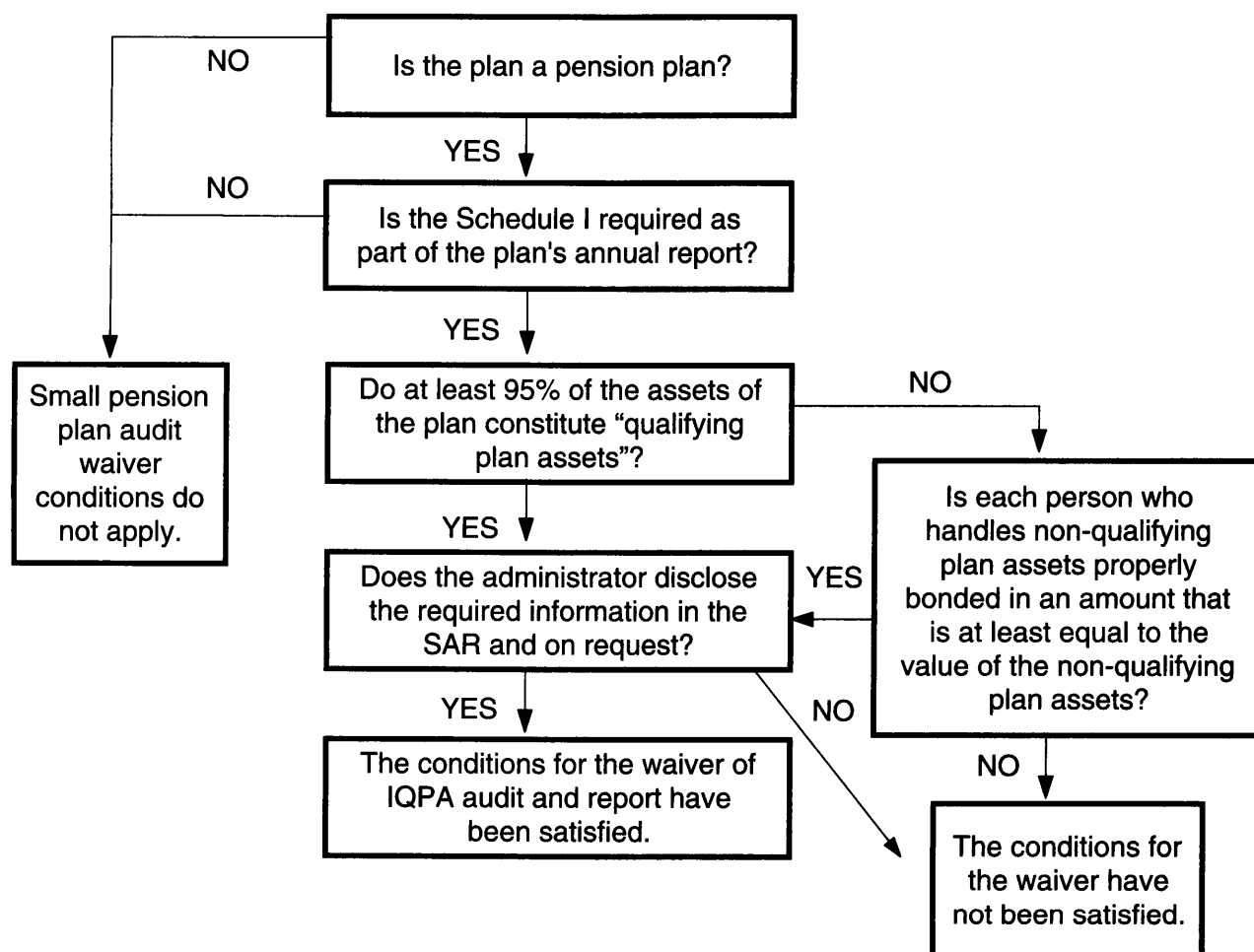
<i>Summary of Major Retirement Plan Law Changes</i>				
<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
16	Rollovers among various types of plans IRC §§ 402, 403, 408, 457, and 3401	Generally distributions from a qualified retirement plan. Section 403(b) annuity, IRA, or Section 457 plan can be rolled over to any of such plans or arrangements.	2002	641–643
17	Vesting IRC § 411(a)	Employer matching contributions must vest under a maximum 3-year cliff or 6-year graded vesting schedule.	Generally effective for plan years beginning after 2001	633
18	Waiver of 60-day rollover rule	The IRS may waive the 60-day rollover period if the failure to provide a waiver would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual.	2002	644
19	Employer-provided retirement advice IRC § 132	Qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan are excludible from income and wages. The benefit must be available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan.	2002	665
20	Deemed IRAs under employer plans IRC § 408	A qualified employer plan may elect to allow employees to make traditional or Roth IRA-type contributions to the plan.	Years beginning after December 31, 2002	602
21	Elimination of user fee for determination letter requests for small employers	User fees will be eliminated for determination letters requested by small employers within 5 years of the adoption of a new plan or within 5 years of the end of a remedial amendment period beginning in the first 5 years the plan is in existence.	2002	620
22	Multiple-use test IRC § 401(m)	The multiple use of the alternative limit test has been repealed. Employers may use the alternative limit to pass both the ADP and the ACP tests.	2002	666

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Appendix D

Small Pension Plan Audit Waiver Summary

Small Pension Plan Audit Waiver (SPPAW) Summary (Applies to Plan Years Beginning on or after April 18, 2001)



Appendix E

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting and Misappropriation of Assets

This appendix contains examples of risk factors presented separately relating to the two types of fraud relevant to the auditor's consideration—that is, fraudulent financial reporting and misappropriation of assets. Risk factors are further classified based on the three conditions generally present when fraud exists:

1. *Incentive/pressure* to perpetrate fraud
2. *Opportunity* to carry out the fraud
3. *Attitude/rationalization* to justify the fraudulent action

Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the engagement team may wish to consider additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

I. RISK FACTORS RELATING TO MISSTATEMENTS ARISING FROM FRAUDULENT FINANCIAL REPORTING

Incentives/Pressures

Financial stability or profitability of the plan is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- Financial stability or profitability of the plan sponsor is threatened by economic, industry, or entity operating conditions
- The plan holds employer securities and the employer is in an industry in which the value of the securities is subject to significant volatility or is not readily determinable
- The plan has limited investment options or has invested significantly in employer assets other than employer securities
- Poor investment results, especially compared to that of other similar plans
- Recurring negative cash flows combined with an underfunded position
- New accounting, statutory, or regulatory requirements, such as legislation that increases benefits of public employee retirement plans (PERs) or the Health Insurance Portability and Accountability Act of 1996 (HIPAA) for health care plans that process their own claims

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Public relations risk of large investment that becomes worthless, especially if a derivative or nonregulated investment such as a hedge fund or "alternative investments"
- Investment return expectations of participants, participating employers, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management

- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as plan sponsor business combinations or multiemployer plan attempts to attract new employers or to prevent departure of current employers

Opportunities

The nature of the industry or the plan's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Senior management of the plan sponsor appointing itself trustee of the plan and having the opportunity in that position to benefit the plan sponsor (for example, to use the plan's money for speculative investing or to support the plan sponsor through purchasing employer assets or supporting a supplier)
- Significant related-party transactions not in the ordinary course of business or with related plans not audited or audited by another firm
- Non-readily marketable investments where valuation is based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate, such as unregulated investments (hedge funds or "alternative investments") or real estate
- In-kind contributions from the plan sponsor

There is ineffective monitoring of management as a result of the following:

- Lack of oversight by plan management of outside service providers such as investment custodians, investment managers, recordkeepers, claims administrators, or paying agents
- Domination of plan management by a single person or small group without compensating controls
- Ineffective board of directors or committee oversight over the financial reporting process and internal controls
- Lack of competence of plan trustees because of background and lack of training

There is a complex or unstable organizational structure as evidenced by the following:

- Difficulty in determining the committee or individuals that have oversight or fiduciary responsibility for the plan
- Turnover of plan management, oversight committee members, counsel, board members, or outside service providers

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls
- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff
- Ineffective accounting and information systems including situations involving reportable conditions

Attitudes/Rationalizations

We may not be able to observe risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting. Nevertheless, if we become aware of the existence of such information, we should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting.

The following matters have come to our attention:

- Ineffective communication, implementation, support, or enforcement of the plan sponsor or plan's values or ethical standards by management or the communication of inappropriate values or ethical standards

- Lack of management candor in dealing with plan participants, claimants, outside service organizations, actuaries, and auditors regarding decisions that could have an impact on plan assets, including restructuring or downsizing arrangements
- Failure by management to have adequate valuations performed, including actuarial valuations
- The plan administrator lacks an understanding of the major regulations that govern the plans (for example, Employee Retirement Income Security Act (ERISA), HIPAA, the Internal Revenue Code (IRC), and State legislation)
- Management displays a significant disregard toward compliance with laws and regulations, such as ERISA, HIPAA, IRC, and Department of Labor (DOL)
- The plan administrator custodian or trustees have been investigated by the DOL, Internal Revenue Service (IRS), Pension Benefit Guaranty Corporation (PBGC), or other party
- The plan has participated in a voluntary compliance program in conjunction with the IRS or DOL. Such participation a possible indication of ineffective management of the plan or controls over the plan
- Management failing to correct known operational deficiencies, prohibited transactions, or reportable conditions on a timely basis

The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:

- Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
- Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report
- Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or oversight committee
- Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

II. RISK FACTORS RELATING TO MISSTATEMENTS ARISING FROM MISAPPROPRIATION OF ASSETS

Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur (for example, ineffective monitoring of management and weaknesses in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exists).

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets. (Access to assets, such as access to participant data communicated to the trustee, may be indirect.)

- Known personal financial pressures affecting employees with access to plan assets

Adverse relationships between the plan sponsor or plan administration and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs
- Recent or anticipated changes to employee compensation or benefit plans

- Promotions, compensation, or other rewards inconsistent with expectations
- Individuals involved in plan administration known to be dissatisfied

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- A company sponsoring multiple defined benefit pension plans, some underfunded, some overfunded
- Lack of qualified outside service provider to serve as trustee and/or custodian of plan assets
- Nonreadily marketable, specialized, or unique investments and management's lack of understanding of such investments (for example, nonregulated investments such as hedge funds and "alternative investments", derivative products, securities lending arrangements, junk bonds, real estate, securities traded in non-U.S. markets, limited partnerships, and real property)

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Lack of appropriate management oversight
- Lack of review of plan investment transactions including accounting for investment income (for example, by the trustee, sponsor, or the plan's investment committee)
- Lack of segregation of duties or independent checks
- Lack of independent preparation and review of reconciliations of trust assets to participant accounts or accounting records of the plan
- Lack of segregation of duties related to benefit payments, contributions, investment transactions, and loans
- Plan administrator does not maintain independent records and periodically check information provided to the custodian
- Lack of appropriate system of authorization and approval of transactions
- Lack of complete and timely reconciliations of assets
- Lack of approval of transactions with parties-in-interest that could lead to prohibited transactions
- Lack of timely and appropriate documentation for transactions
- Trustee does not prepare required supplemental information (for example, historical cost records not maintained for non-participant directed accounts)
- Lack of controls over benefit payments, including the termination of payments in accordance with plan provisions
- Lack of segregation of plan assets from the sponsor's assets or inappropriate access to plan assets by plan sponsor
- SAS No. 70 report indicating a lack of adequate controls at an outside service provider
- Use of a service provider that does not provide a SAS No. 70 report
- Unreconciled differences between net assets available for benefits per the trustee/custodian records and the recorded participant accounts for a defined contribution plan (unallocated assets or liabilities)

- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation
- Inadequate access controls over automated records, including controls over and review of computer systems event logs

Attitudes/Rationalizations

We may not be able to observe risk factors reflective of employee attitudes/rationalizations that allow them to justify misappropriations of assets. Nevertheless, if we become aware of the existence of such information, we should consider it in identifying the risks of material misstatement arising from misappropriation of assets.

If we have observed the following attitudes or behavior of employees who have access to assets susceptible to misappropriation:

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies
- Behavior indicating displeasure or dissatisfaction with the plan or plan sponsor or their treatment of the employee
- Changes in behavior or lifestyle that may indicate assets have been misappropriated

Appendix F

Governmental Employee Benefit Plans

This section addresses audit and accounting issues unique to governmental employee benefit plans (governmental plans). Auditors of governmental plans should also see the AICPA Audit and Accounting Guides *Audits of State and Local Governments (Non-GASB 34 Edition)*, and *Audits of State and Local Governments (GASB 34 Edition)*, and the AICPA Audit Risk Alert *State and Local Governmental Developments* [AAM section 8070].

Help Desk—The accounting for many governmental plans is prescribed by Governmental Accounting Standards Board (GASB) standards, primarily GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*. The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the EBP Guide) and related AICPA publications (such as this Audit Risk Alert, the checklists, and Practice Aids listed in the “Related Publications” section of this Alert) are designed to address issues related to plans sponsored by commercial or not-for-profit private sector entities, and the accounting provisions in the EBP Guide do not apply to governmental plans. However, portions of those publications, including this Alert, may be useful to auditors of governmental plans. For example, auditors should consider referring to the EBP Guide for specific auditing considerations relating to governmental plans, such as evaluating actuarial information. Although the audit objectives for governmental plans are similar to those for private-sector pension plans, the auditor should be aware that the Employee Retirement Income Security Act of 1974 (ERISA) does not apply to governmental entities. Instead, state and local laws and regulations govern the operations of governmental plans.

Current Trends

The funding levels for public sector retirement plans have been reduced by three years of underperforming investment returns, and funding, like funding for all governmental programs, is threatened by lower tax revenues and governmental deficits.

A study of 199 public pension funds performed by Greenwich Associates revealed an average asset loss of 9.3 percent from 2001 to 2002, which followed an 8.9 percent loss from 2000 to 2001. As a result, the percentage of underfunded plans rose from 52 percent overall, and to 58 percent among funds with over \$5 billion in assets. U.S. equity markets fell for the third year in a row, which has not happened since the period 1939 to 1941. The S&P SuperComposite 1500 fell 21.3 percent in 2002 after falling 10.6 percent in 2001 and 7.0 percent in 2000.

Funding of benefit programs may be tested as state legislatures face a minimum \$68.5 billion budget shortfall for fiscal year 2004. According to the National Conference of State Legislatures, President Angela Monson, a state senator from Oklahoma, says, “Thirty-three states estimate budget gaps in excess of 5 percent, with 18 of those facing gaps above 10 percent. There is great cause for concern since the deficit numbers continue to grow at an alarming rate.”

Audit Risks

With the continued investment losses and underfunding of plans, many funds have undertaken asset allocation or asset/liability studies. Auditors should consider reviewing such studies, including comparing allocation targets and ranges with the current asset allocation to determine if funds are within policy limits. Also, benefit cash flows should be monitored for any possible changes in contribution rates, early retirement incentives, and/or increased purchase service activity.

New and Proposed GASB Pronouncements

Help Desk—For further information on recent exposure drafts outstanding, visit the Web site <http://accounting.rutgers.edu/raw/gasb/welcome.htm>.

GASB Issues Standard to Improve Disclosures on Deposit and Investment Risk

In an effort to provide the public with better information about the risks that could potentially affect a government's ability to provide services and pay its debts, the GASB has published GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, an amendment of GASB Statement No. 3. The Statement amends GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, and addresses additional risks to which governments are exposed.

The new accounting guidance requires that state and local governments communicate key information about deposit and investment risks, frequently one of the largest assets on a government's balance sheet. Under GASB Statement No. 40, state and local governments are required to disclose information covering four principal areas:

1. Investment credit risk disclosures, including credit quality information issued by rating agencies
2. Interest rate disclosures that include investment maturity information, such as weighted average maturities or specification identification of the securities
3. Interest rate sensitivity for investments that are highly sensitive to changes in interest rates (for example, inverse floaters, enhanced variable-rate investments, and certain asset-backed securities)
4. Foreign exchange exposures that would indicate the foreign investment's denomination

The provisions of GASB Statement No. 40 are effective for financial statements for periods beginning after June 15, 2004. Earlier application is encouraged.

Help Desk—GASB Statement No. 40 (product no. GS40) can be ordered through the GASB's Order Department at (800) 748-0659 or online via its Web site at www.gasb.org.

GASB Issues Technical Bulletin to Improve Disclosures About Derivatives

In an effort to improve disclosures about the risks associated with derivative contracts, the GASB has released for public comment accounting guidance that would provide more consistent reporting by state and local governments. The proposed Technical Bulletin, *Disclosure Requirements for Derivatives Not Presented at Fair Value on the Statement of Net Assets*, is designed to increase the public's understanding of the significance of derivatives to a government's net assets and would provide key information about the potential effects on future cash flows.

While state and local governments use a vast array of increasingly complex derivative instruments to manage debt and investments, they also may be assuming significant risks. Governments must communicate those risks to financial statement users and the proposed Technical Bulletin would help clarify existing accounting guidance so that more consistent disclosures can be made across all governments.

Governments would be required to disclose the derivative's objective, its terms, fair value, and risks. The proposed accounting guidance would require governments to disclose in their financial statements credit risk, interest rate risk, basis risk, termination risk, rollover risk and market access risk.

Help Desk—This Technical Bulletin would be effective for periods ending after June 15, 2003. The proposed Technical Bulletin is available from the GASB's Web site. Comments on the proposed documents may be made through May 16, 2003.

Postemployment Benefits Exposure Drafts

The GASB issued two exposure drafts of proposed Statements on financial reporting of postemployment benefits other than pensions (known as other postemployment benefits, or OPEB) in February 2003.

- *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.* This proposed Statement establishes standards for the measurement, recognition, and display of other postemployment employee benefits (OPEB) expense or expenditures and related liabilities in the financial reports of state and local governments.
- *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans.* This proposed Statement establishes uniform financial reporting standards for OPEB plans and would supersede the previously issued interim guidance in GASB Statement No. 26.

Other Governmental Employee Benefit Plan Resources

The National Conference on Public Employee Retirement Systems (NCPERS) issued a special report on the evolution of the structure of defined benefit and defined contribution plans in the public sector. The report is titled “The Evolution of Public Sector Pension Plans.” The report details six examples of innovative state plans that offer variations of traditional defined benefit plans. The report also reviews the issues that have driven the discussion of defined contribution plans as well as the adoption of hybrid plans and the economic factors that have influenced the development of public sector plans. A copy of this special report has been sent to every NCPERS member. Additional copies are free to NCPERS members by calling the NCPERS office at (202) 624-1456.

Public Pension Coordinating Council’s 2001 Survey of State and Local Government Employee Retirement Systems

The 2001 Survey of State and Local Government Employee Retirement Systems is available online at <http://ppcc.grsnet.com>. The report presents summary statistical analysis of state and local government employee systems surveyed by the Public Pension Coordinating Council in the summer of 2001 and published in March of 2002.

Resources

See the “Information Resources” section of the AICPA Audit Risk Alert *State and Local Governmental Developments—2002*, for a listing of resources for governmental entities, including governmental plans.

[The next page is 8179.]

AAM Section 8070

State and Local Governmental Developments—2003

NOTICE TO READERS

We, as members of the AICPA staff, have developed this Audit Risk Alert to provide you, as an auditor of financial statements of state and local governments¹, with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits you perform. This document presents brief summaries of recently issued accounting and auditing pronouncements and legal and regulatory provisions. We present those summaries for your information only; you should not rely on them as a substitute for a complete reading of the source material.

This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150), as amended. Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply the SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Economic and Industry Developments

The State of the Economy

.01 State and local governments are taking severe action to weather these difficult times. Last year we saw some tax increases, budget trimming, and the use of rainy-day funds. This year, those techniques are being supplemented with additional tax increases (on a scale not seen since 1992), tax restructuring, across-the-board budget cuts, hiring freezes, layoffs, early retirement incentives, and program restructuring, especially in health care programs. Some governments are using current tobacco settlement payments, which are significantly lower than originally projected, to fill budget gaps, as well as using future settlement payments to securitize bonded debt. State governments are stepping up their efforts to tax Internet sales. (See the later discussion in this section titled "Taxation of Internet Sales.") Further, state cuts in funding to local governments are adding to the financial stress those entities are facing. To increase revenue, some governments are trying "data mining," a process of identifying unpaid taxes and fees by looking at other, related data. For example, a government might use overseas purchases declared on customs forms to identify unpaid use taxes and use self-employment income in tax returns to identify unpaid business licenses. Governments also issued debt, including refunding debt, in record amounts in 2002, taking advantage of historically low interest rates.

¹ Until 2003, this annual Alert has included the topic of single audits—audits performed under Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133). Beginning this year, we address single audits matters separately in the Audit Risk Alert, titled *Single Audits* [AAM section 8220]. The annual Single Audit Alert will provide auditors of organizations receiving federal awards with an overview of recent industry, regulatory, and professional developments that may affect the audits they perform.

.02 In the face of these uncertain economic times, governments may consider using “creative” budgeting, financing, and financial reporting techniques to avoid the appearance of deficit financial positions. They may find innovative ways to minimize the reporting of costs, maximize the reporting of revenues and unrestricted net assets, and use restricted resources for unrestricted purposes.

Help Desk—The Rockefeller Institute of Government’s new Web site, “The Gateway to State and Local Government Information,” at <http://StateAndLocalGateway.rockinst.org>, is a clearinghouse of information on state and local government finances that can help you to keep up-to-date on economic issues facing governmental entities.

Taxation of Internet Sales

.03 The taxation of Internet sales remains an ongoing issue. State and local governments are concerned about losing billions of revenue dollars annually because of untaxed Internet sales. Internet businesses claim that disparities in sales tax systems among the various jurisdictions make it too burdensome to administer sales tax collections.

.04 Late in 2002, a majority of states approved an interstate agreement to simplify their sales tax laws. The agreement will become effective once a certain number of states have enacted conforming legislation. In response, some of the nation’s largest retailers have started voluntarily to collect taxes on their Internet sales. However, before state and local governments can enforce the taxation of Internet sales, the federal government must pass legislation permitting it. The Internet Tax Nondiscrimination Act (Public Law [P.L.] 107-075), which expires November 1, 2003, bans new Internet access taxes and new, multiple, and discriminatory taxes on electronic commerce. Legislators are considering bills in the 108th Congress to make the ban permanent. Surely, the states will be adding their voice to that debate.

Governing Board Scrutiny

.05 You may find governing boards, audit committees, and those with oversight responsibility for financial matters more attentive to and involved with this year’s audit. There are several reasons why these groups are on a heightened state of alert:

- They are concerned with the financial stress the entity is facing. (See the earlier discussion in this section titled “The State of the Economy.”)
- They are taking their oversight responsibilities more seriously in the wake of recent accounting scandals and the passage of the Sarbanes-Oxley Act of 2002 (P.L. 107-204).
- They are receiving new financial information because of the implementation of Government Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*. (You might find them especially interested in the tone and content of the information in the management’s discussion and analysis [MD&A].)
- You are bringing them more directly into the audit process through the fraud inquiries required by Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). (See the discussion of SAS No. 99 and the associated AICPA publications in the later sections of this Alert titled “Recent AICPA Auditing Standards and Other Guidance” and “Focus on Fraud.”)

This increased attention and involvement can have a positive effect on your audits and your relationships with your clients. However, you will likely need to plan some extra time in your audit budgets because of it.

Regulatory, Legislative, and Other Developments

Internal Revenue Service Activities

.06 We have included in the past few Alerts lengthy discussions about how Internal Revenue Service (IRS) activities might affect the financial statement audits of your state and local government clients. You should be aware of IRS concerns about noncompliance that could have a direct and material effect on the determination of financial statement amounts. While there are some new IRS concerns every year, many of them stay the same.

.07 This year the IRS continues to be concerned about and use various techniques to examine compliance with laws and regulations relating to, among other matters, settlements for back pay, worker versus independent contractor classification, taxable fringe benefits, Federal Insurance Contribution Act (FICA) taxes, tax-sheltered annuities and deferred compensation plans, and yield burning and arbitrage on tax-exempt bonds. In addition, changes in IRS regulations, some of which we highlight below, might result in changes in a government's activities relating to, for example, its retirement plans or tax-exempt debt.

.08 There is a simple way to obtain targeted, up-to-date information about relevant IRS activities—go to the appropriate sections of the IRS Web site. The portion of the IRS Web site relating to the Tax Exempt and Government Entities (TE/GE) Operating Division:

- Provides separate pages for state and local governments, Indian tribal governments, tax-exempt bonds, and employee plans
- Provides links to relevant regulations, revenue rulings, revenue procedures, notices, announcements, publications (such as the 2002 versions of Publications 963, *Federal-State Reference Guide: Social Security Coverage and FICA Reporting by State and Local Government Employers*, and 3908, *Gaming Tax Law for Indian Tribal Governments*), and educational materials
- Allows you to access and subscribe to electronic newsletters, such as the *Federal, State, and Local Government Newsletter* and *Employee Plans News*
- Gives you information about outreach efforts, voluntary correction programs (such as the voluntary closing agreement program for tax-exempt bonds), and contacts for appropriate IRS and other federal agency personnel.

Help Desk—Check it out! Go to www.irs.gov and follow the links to government entities (which will take you to separate pages for federal, state, and local governments; Indian tribal governments; and tax-exempt bonds) and retirement plans.

Employment Issues

.09 This year, the TE/GE office of Federal, State, and Local Governments (FSLG) will try to increase voluntary compliance with the regulations for information returns (Forms 1099 and W-2) by conducting “compliance checks” and examinations. Compliance checks, which are not examinations, are used to verify that information returns are accurately and timely reported. The FSLG also will be addressing information return penalties. Each state-based FSLG office has developed plans to provide educational information to governments and practitioner and government associations about information return reporting and other employment tax issues.

Tax-Exempt Bonds

.10 *Enforcement activities.* In last year's Alert, we explained the IRS's enforcement activities and global settlements relating to yield burning on tax-exempt bonds. The IRS continues to cast a wider net, gathering many firms that did not participate in the global settlements and even expanding their concerns into cash-funded

defeasance escrows (in addition to the bond-funded escrows that have been targeted for several years). An interesting aspect of this activity is that the brokers often are paying small refunds to the issuers. In some cases, the issuers will have to pay those refunds to the IRS. If a government you audit receives such a refund, it should consult a competent tax adviser about the consequences.

.11 As its examiners gain experience, the IRS is auditing more types of tax-exempt bonds. Its experience with “blind pools” has piqued its interest further, and such pooled financing issues (particularly, pools from which few, if any, loans were made) can be expected to be a continuing target of IRS audits for some time. It is also worth noting that the IRS’s interest in solid waste bonds and arbitrage rebate payments has not diminished. In addition, relatively new areas of focus include single family and multifamily mortgage bonds and student loan bonds. Finally, *any* type of bond issue where the project(s) to be financed never came about can anticipate intense scrutiny, in the event that an IRS audit letter is received.

.12 An easily overlooked problem for which auditors should be on the lookout is *change in use* of financed facilities. Bond proceeds may be used to finance a project that is initially eligible for tax-exempt financing, but the use of the property later changes to an ineligible use (for instance, space that is no longer being needed for a government purpose could be leased to a private business, or a government service using bond-financed facilities could be privatized). If this should occur with respect to any portion of such a facility, the government should consult a competent tax adviser about the consequences.

.13 In last year’s Alert, we discussed an IRS Voluntary Closing Agreement Program (VCAP) that was announced on October 1, 2001. This program continues in full force and can be a very useful tool to resolve problems that a government discovers with its tax-exempt bonds. Refer to the IRS Web site at www.irs.gov for more details.

.14 *Output facility regulations.* In the September 23, 2002, *Federal Register* (67 FR 59756), the IRS issued regulations that provide guidance for applying the private activity bond restrictions to tax-exempt bonds issued by state and local governments for output facilities, which generally are facilities for the generation and transmission of electricity. The final regulations apply to bonds sold on or after November 22, 2002.

.15 *Arbitrage safe harbor.* In Revenue Procedure 2002-31 (*Internal Revenue Bulletin* 2002-19, May 13, 2002), the IRS finalized an arbitrage safe harbor under which an issue of certain short-term tax or revenue anticipation bonds will not be treated as outstanding longer than is reasonably necessary to accomplish the governmental purposes of the bonds. The revenue procedure applies to bonds sold after May 13, 2002.

Help Desk—The IRS recently issued a guide to provide an overview of federal tax law requirements pertaining to tax-exempt municipal bonds. Publication 4079, *Tax-Exempt Governmental Bonds Compliance Guide*, is available on the IRS Web site at www.irs.gov/pub/irs-pdf/p4079.pdf.

Employee Plans

.16 The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-016) included comprehensive pension reforms that significantly changed how traditional retirement programs are operated, including programs that cover governmental employees. See last year’s Alert for an overview of the effect of the Act.

.17 In the July 11, 2003, *Federal Register* (68 FR 41230), the IRS issued final regulations on eligible Section 457(b) deferred compensation plans. The regulations reflect the changes made to 457 plans by various laws enacted over the past two decades. They also make various technical changes and clarifications to the existing final regulations on many discrete issues. The final regulations are effective upon issuance and generally applicable to taxable years beginning after December 31, 2001.

.18 In Notice 2003-20 (*Internal Revenue Bulletin* 2003-19, May 12, 2003), the IRS provides needed and helpful guidance on the withholding and reporting requirements applicable to 457(b) plans. Guidance in the

Notice includes timing and reporting for income tax withholdings and FICA payments. The rules in the Notice are effective for deferrals and distributions made after December 31, 2001.

Securities and Exchange Commission Developments

.19 Last year, the Securities and Exchange Commission's (SEC's) Office of Municipal Securities studied the system of nationally recognized municipal securities information repositories (NRMSIRs). The study found that municipal securities issuers and conduit borrowers frequently are not filing their contractually required annual continuing disclosures. (See the discussion of continuing disclosure requirements in the SEC section of last year's Alert.) Issuers and conduit borrowers frequently fail to make the required filings because they are not aware of their obligation or the potential consequences of noncompliance. Such potential consequences are (1) broker-dealers may become unable to recommend the purchase of the entity's securities, reducing their liquidity, and (2) issuers and conduit borrowers must disclose their failures to file in the offering document for their next bond issue. If an issuer or conduit borrower repeatedly fails to meet its obligation to file in a timely manner, broker-dealers may be unable to underwrite or bid for the offering. The SEC recently reminded broker-dealers of these obligations and of its intention to enforce them.

.20 In last year's Alert, we discussed how you might become aware during a financial statement audit that a government has not complied with its continuing disclosure obligations, and that such noncompliance might have a material indirect effect on the financial statements. We want to again remind you that when you become aware of such noncompliance, you should consider the adequacy of the government's financial statement disclosure about the violations and actions taken to address them as well as the effect of nondisclosure on the auditor's report. Should you find such violations, you also may want to assess the entity's internal control over making the required filings and report deficiencies in that internal control in the management letter.

.21 You also should be aware of the increasing need for governments, especially municipal securities issuers and conduit borrowers, to have their financial statements produced in an electronic format. Issuers and conduit borrowers are increasing their use of the Internet to disseminate information, including financial statements. Further, the Municipal Council is developing a central electronic filing location that will simultaneously forward each filing to every NRMSIR (commonly referred to as an electronic "post office") for issuers and conduit borrowers to use to make filings with NRMSIRs. This post office will probably begin accepting filings during the next year. (The Municipal Council is a group of 20 organizations representing all sectors of the municipal market.) The SEC supports that effort and is expected to consider mandating use of an electronic post office for all NRMSIR filings. Therefore, the production of financial statements in an electronic format—and one that is secure, such as a portable document format (PDF) file—will meet both current and future needs.

The Sarbanes-Oxley Act of 2002

.22 Congress passed, and President Bush signed, the Sarbanes-Oxley Act of 2002 (the Act), providing unprecedented new requirements for auditors of public companies, corporations, and Wall Street. Since the Act's issuance, several state legislators, regulators, and other elected or appointed officials are seeking to duplicate and/or extend provisions of the Act to nonpublic companies. Further, the General Accounting Office (GAO), which issues *Government Auditing Standards*, has stated that it will be monitoring the actions of the AICPA and the new Public Company Accounting Oversight Board (PCAOB) (which was established by the Act) to determine if any clarifying guidance needs to be added to its auditing standards. It is not clear at this point how or if these activities will affect audits of state and local governments. For this reason, you may want to follow developments related to the Act over the next year. See the related discussion on certain recent proposed auditing standards related to the Act in the section of this Alert titled "Proposed AICPA Auditing and Attestation Standards."

Help Desk—For information about the Sarbanes-Oxley Act, see the Sarbanes-Oxley Act/PCAOB Implementation section of the AICPA Web site at www.aicpa.org/sarbanes/index.asp. This section includes background information; links to AICPA implementation guidance; and information on federal regulator, state regulator, and PCAOB activities related to the implementation of the Act.

Audit and Attestation Issues and Developments

Recent AICPA Auditing Standards and Other Guidance

SAS No. 97, Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles

.23 Issued in June 2002, SAS No. 97 (AICPA, *Professional Standards*, vol. 1, AU sec. 625) revises SAS No. 50, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 625). The Statement prohibits an accountant from providing a written report on the application of accounting principles not involving facts and circumstances of a specific entity. It provides guidance that a reporting accountant should apply when preparing a written report or providing oral advice on the application of accounting principles to specified transactions involving facts and circumstances of a specific entity, among other things. SAS No. 97 is effective for written reports issued or oral advice provided on or after June 30, 2002, with earlier application permissible.

SAS No. 98, Omnibus Statement on Auditing Standards—2002

.24 SAS No. 98, issued in September 2002, includes numerous accumulated revisions to various SASs. Among items that might be relevant to the audits of state and local governments are:

- An amendment to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550.07), which indicates that the auditor may express an opinion, in relation to the basic financial statements taken as a whole, on supplementary information and other information that has been subjected to the auditing procedures applied in the audit of those basic financial statements. It also describes, in more detail, the auditor's reporting on the information and that the auditor should use the guidance provided in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551.12 and .14).
- An amendment to SAS No. 52, *Omnibus Statement on Auditing Standards—1987* (AICPA, *Professional Standards*, vol. 1, AU sec. 558.02 and .08–.10, "Required Supplementary Information"), which revises the applicability section of the SAS to include all sources of generally accepted accounting principles (GAAP), including AICPA industry Audit and Accounting Guides.
- An amendment to SAS No. 29 (AU sec. 551.12 and .15), which clarifies that an auditor can report whether required supplementary information (RSI) in an auditor-submitted document that is neither incomplete nor otherwise deficient is fairly stated in relation to the basic financial statements taken as a whole. To report in this manner, the RSI must have been subjected to the auditing procedures applied in the audit of the basic financial statements.

.25 Among the amendments and revisions included in SAS No. 98 are others related to SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150.05); SAS No. 47, *Audit Risk and Materiality* (AICPA, *Professional Standards*, vol. 1, AU sec. 312.34–.41); SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324.34–.41); SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.65); and SAS No. 1, section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530.03–.05) (which clarifies the auditor's responsibility with respect to subsequent events). With the exception of the effective date of the

amendment to SAS No. 70 and the rescission of Auditing Interpretation No. 6 of SAS No. 70 (effective for reports issued on or after January 1, 2003), all amendments were effective when SAS No. 98 was issued.

SAS No. 99, Consideration of Fraud in a Financial Statement Audit

.26 SAS No. 99 (AICPA, *Professional Standards*, vol. 1, AU sec. 316), issued in October 2002, supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316A). It also amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230), and SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333). SAS No. 99 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. It provides guidance as it relates to fraud in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS).

.27 SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002, with early application permissible. See the subsequent section of this Alert, "Focus on Fraud," for additional related information.

SAS No. 100, Interim Financial Information

.28 SAS No. 100 (AICPA, *Professional Standards*, vol. 1, AU sec. 722), issued in November 2002, supersedes SAS No. 71, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722A). SAS No. 100 applies to accountants who conduct reviews of interim information of an SEC registrant or non-SEC registrant filing with a regulatory agency (note that the standard defines a *regulatory agency* as the SEC and the following agencies with which an entity files periodic reports pursuant to the Securities Exchange Act of 1934: Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve System, or the Office of Thrift Supervision). SAS No. 100 establishes standards on the nature, timing, and extent of procedures to be performed by an independent accountant when conducting a review of interim financial information. Although such a review is not a frequent occurrence, you may be engaged to review interim financial information as part of a governmental entity's municipal securities filing. This guidance is effective for interim periods within fiscal years beginning after December 15, 2002, with earlier application permitted. See the related discussion about the proposed SAS that would amend SAS No. 100 in the section of this Alert, "Proposed AICPA Auditing and Attestation Standards."

SAS No. 101, Auditing Fair Value Measurements and Disclosures

.29 GAAP requires fair value measurements and disclosures for many investments and investment-related transactions. For example, GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, as amended, requires that investments be reported at fair value. Issued in January 2003, SAS No. 101 (AICPA, *Professional Standards*, vol. 1, AU sec. 328), establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements. More specifically, SAS No. 101 addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. SAS No. 101 is effective for audits of financial statements for periods beginning on or after June 15, 2003, with earlier application permitted.

Auditing Interpretations

.30 Among the AICPA's recent Interpretations that could relate to your state and local governmental clients is Interpretation No. 15, "Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations," of SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508.60–75). This Interpretation clarifies guidance for circumstances when prior-period financial statements audited by a predecessor auditor who has ceased operations are

presented for comparative purposes with current-period audited financial statements. It provides, among other things, an example of the reference that would be added to the introductory paragraph of the successor auditor's report when prior-period financial statements are unchanged. It also provides other reporting guidance for situations when such prior-period financial statements are restated.

Recent AICPA Attestation Standards

.31 In September 2002, the Auditing Standards Board (ASB) issued Statement on Standards for Attestation Engagements (SSAE) No. 12, *Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101). SSAE No. 12 is an omnibus standard that amends various standards for matters that have accumulated over time. It was primarily issued to make changes to the attestation standards that are consistent with those made to the auditing standards via SAS No. 98 (see the previous discussion in the section of this Alert titled "Recent AICPA Auditing Standards and Other Guidance"). It also clarifies the relationship between the attestation standards and the AICPA's quality control standards to indicate that deficiencies in or instances of noncompliance with a firm's quality control policies and procedures do not, in and of themselves, indicate that a particular engagement was not performed in accordance with attestation standards.

Proposed AICPA Auditing and Attestation Standards

.32 The ASB has released several exposure drafts that might affect your audits of state and local governmental financial statements or the environment in which you are conducting your audits this year. These proposals include the following:

- *Proposed SASs related to audit risk.* The ASB released seven proposed SASs related to the audit risk assessment process to change audit practice to result in more efficient audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model. The proposed SASs are:
 - *Amendment to SAS No. 95, Generally Accepted Auditing Standards*
 - *Audit Evidence* (which would supersede SAS No. 31 of the same name [AICPA, *Professional Standards*, vol. 1, AU sec. 326])
 - *Audit Risk and Materiality in Conducting an Audit* (which would supersede SAS No. 47 of the same name)
 - *Planning and Supervision* (which would supersede SAS No. 22 of the same name [AICPA, *Professional Standards*, vol. 1, AU sec. 311])
 - New SASs titled *Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement* and *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (which together would supersede SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* [AICPA, *Professional Standards*, vol. 1, AU secs. 313 and 334], and SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 319])
 - An amendment to SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350).
- *Proposed SAS, Sarbanes-Oxley Omnibus.* This proposed standard includes amendments to various standards to reflect certain provisions of the Sarbanes-Oxley Act of 2002 and the final SEC rules titled *Retention of Records Relevant to Audits and Reviews* and *Strengthening the Commission's Requirements Regarding Auditor Independence*. Although many of the revisions would only apply to SEC engagements, for example, requirements for a review by a reviewing partner of financial statements for SEC engagements and for the required reporting on internal control over financial reporting (see the related discussion in the following bulleted item), there are other proposed changes that would affect governmental audits. For example, the statement would amend SAS No. 96, *Audit Documentation*

(AICPA, *Professional Standards*, vol. 1, AU sec. 339), to require that certain audit documentation be retained for a period of seven years from the end of the audit or review period. This standard also would amend SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), to establish a definition of an audit committee and to revise certain existing communication requirements or add new requirements.

- *Proposed SASs and SSAE related to reporting on internal control.* The Sarbanes-Oxley Act of 2002 requires that auditors of public company financial statements also report on the effectiveness of management's internal control over financial reporting. The proposed SASs titled *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With Financial Statement Audit* and *Amendment to SAS No. 100, Interim Reporting*, and the proposed SSAE titled *Reporting on an Entity's Internal Control Over Financial Reporting* (which will supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Standards: Revision and Recodification* [AICPA, *Professional Standards*, vol. 1, AT sec. 501], as amended), establish standards and provide guidance to auditors in fulfilling that responsibility. Currently there is no similar requirement for an auditor to report on the effectiveness of a government's internal control over financial reporting. However, the proposed SSAE, when finalized, would be guidance for an auditor of a state or local government entity if he or she were engaged to provide such assurance on controls.
- *Proposed SAS related to communicating internal control matters.* This SAS, titled *Communication of Internal Control Related Matters Noted in an Audit*, would supersede SAS No. 60 of the same name (AICPA, *Professional Standards*, vol. 1, AU sec. 325). It establishes and provides guidance to enhance the auditor communication responsibility to the audit committee (or its equivalent) concerning significant deficiencies and material weaknesses in internal control noted in a financial statement audit. One result of this proposed standard is that the term *reportable condition* would be replaced by the term *significant deficiency*. If the standards are finalized as proposed, this would result in possible future report wording changes in audits of state and local governments (for example, in the reporting required under *Government Auditing Standards*).

Help Desk—For information about the current status of these proposed standards, go to the AICPA Web site at www.aicpa.org/members/div/auditstd/drafts.htm.

Focus on Fraud

.33 Recent news in corporate America has revealed fraud-related events in several major industries. The effects of fraud can extend well beyond these specific industry boundaries to affect many types of entities, including governments. Preparers and auditors of state and local government entities' financial statements should make sure that they are aware of fraud factors and their related risks as they plan and conduct their engagements.

.34 The AICPA has taken an active role, as noted in the following endeavors, in responding to the news of recent fraud events, both independently and in conjunction with other organizations. While this section is not all-encompassing, it identifies the types of activities surrounding fraud information that you can consider.

Help Desk—For more information on fraud and fraud-related resources, see the AICPA Web site at www.aicpa.org/antifraud/additional_info.asp.

Issuance of SAS No. 99

.35 The AICPA's issuance of SAS No. 99, discussed previously in this section of the Alert, was a pivotal step in providing standards and guidance for auditors in detecting material fraud. However, the story does not stop there. The fight against fraud is not just the external auditor's responsibility. Rather, other key players in this focus on fraud include internal auditors, management, governing and other boards, audit committees, and employees.

.36 The issuance of this far-reaching standard heightens efforts in the battle against fraud by providing additional standards and guidance that extends beyond its predecessor, SAS No. 82 (of the same name). It also provides examples of conditions that are conducive to fraud risk, among other matters. Consider the following information, for example.

.37 There are two types of misstatements relevant to the auditor's consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting.
- Misstatements arising from misappropriation of assets.

.38 SAS No. 99 highlights three conditions that are generally present when fraud occurs. However, this does not mean that whenever these conditions are present, there is likely to be fraud or, on the other hand, that if any of these conditions is not present, that fraud is not likely to occur. Your professional judgment is important when assessing any entity for the possibility of fraud, as it is in numerous other audit matters.

.39 For each fraud-related condition included here, we present related examples that apply more specifically to the state and local government environment. These conditions include the following:

- *Incentives/pressures.* First, management or other employees have an incentive or are under pressure, which provides a reason to commit fraud. Examples might include expectations of laws or regulations that will limit resources, anticipated funding cuts for the entity, public pressures to provide more services with fewer dollars, declining property or other tax base, entity investment values that have been negatively affected by the market, the use of complex or "innovative" financing mechanisms, and insufficient cash flows to cover expenditures, to name a few.
- *Opportunities.* Second, circumstances exist—for instance, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an opportunity for a fraud to be perpetrated. Examples of opportunities include the governing board accepts management's recommendations and actions without query or debate; the entity is subject to complex or frequently changing accounting requirements; the entity makes excessive use of separate funds, internal service funds, or interfund and internal activity; the budget is not prepared by the appropriate level of management or is prepared without input of those who understand the budgetary aspects of the entity's activities; or the entity awards financially significant contracts without competitive bids or without due consideration of vendor qualifications.
- *Attitudes/rationalizations.* Third, those involved are able to rationalize committing a fraudulent act. Examples include a governing board that displays significant disregard for regulatory, legal, or oversight requirements or other regulatory authorities; management that exhibits an attitude that funds must be spent on a "use or lose" basis in order to sustain future funding levels; or management that fails to effectively follow up on questions about financial position, financial performance, or budget variances.

.40 Among its many topics, the SAS includes sections addressing a description and characteristics of fraud; the importance of exercising professional skepticism; the importance of discussions among engagement personnel regarding risks of material misstatement due to fraud; the need to obtain information required to identify risks of material misstatement due to fraud; the identification of risks that may result in a material misstatement due to fraud; the assessment of identified risks, after taking into account an evaluation of the entity's programs and controls that address the risks; responses to the results of the assessment; evaluation of audit evidence; communication about possible fraud to management, the audit committee, and others; and documentation of the auditor's considerations of fraud.

Help Desk—For a more complete summary of information of SAS No. 99, please see the AICPA Web site at www.aicpa.org and click on Audit and Attest Standards, then Technical

Activities and Publications, and then Summary of Recently Issued Standards. See also the AICPA Audit and Accounting Guides *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, and *Audits of State and Local Governments (GASB 34 Edition)*, which have both been updated to reflect the provisions of SAS No. 99.

AICPA's Antifraud and Corporate Responsibility Resource Center

.41 In the quest for combatting fraud, you might find the tools and information you need online, in the AICPA's Antifraud and Corporate Responsibility Resource Center (www.aicpa.org/antifraud/). The Center allows you to select optional ways to learn about fraud as it relates to you and to learn about the topic itself. As of this writing, spotlights are on the new Web-based fraud and ethics case studies and commentaries recently issued; the AICPA antifraud Web cast series; the interactive CPA course *Fraud and the CPA*; and a competency model that allows you to assess your overall skills and proficiencies as they relate to fraud prevention, detection, and investigation; among other topics. In addition, the site offers press releases and newsworthy items on other AICPA courses related to prevention and detection and an overview of the AICPA Antifraud and Corporate Responsibility Program.

Help Desk—To find out more about fraud-related topics, go to the AICPA Web site at www.aicpa.org, click on Antifraud Resource Center, and begin exploring.

Other Fraud-Related Tools

.42 We discuss the AICPA's Practice Aid *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide* in the later section of this Alert titled "AICPA Issues Three Practice Aids Relevant to State and Local Governments." The fraud detection Practice Aid, which includes guidance specifically related to audits of state and local governments, should prove to be a big help as you plan and prepare for your audits.

.43 The AICPA's Fraud Task Force of the Auditing Standards Board has also issued the document, "Management Antifraud Programs and Controls: Guidance to Help Prevent, Deter, and Detect Fraud," which appears as an exhibit to SAS No. 99. Issued jointly by the AICPA and other organizations focusing on fraud, the document, among other things, identifies measures entities can implement to prevent, deter, and detect fraud.

Help Desk—To obtain a copy of SAS No. 99, which includes the exhibit mentioned here, contact AICPA's Member Services at (888) 777-7077 and ask for product number 060701kk. The exhibit is also available on the AICPA's Web site at www.aicpa.org (click on Audit and Attest Standards and then on Technical Activities and Publications).

2003 Conforming Changes to Audit and Accounting Guides

State and Local Government Guides

.44 We have updated the AICPA's Audit and Accounting Guides *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, and *Audits of State and Local Governments (GASB 34 Edition)*, for conforming changes as of May 1, 2003. Appendixes in each Guide detail all changes. We made revisions for or added information alerting auditors to the issuance or effective dates of (1) SASs through SAS No. 101; (2) Ethics Interpretation 101-10, "The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12); (3) *Government Auditing Standards* Amendment No. 3, *Independence*, and the recent overhaul to *Government Auditing Standards* issued by the General Accounting Office (GAO) (see the discussion of these new standards in the section of this Alert titled "Government Auditing Standards Developments"); (4) GASB Statements No. 39 through No. 41; (5) the GASB's Technical Bulletin 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*; and (6) the GASB staff's *Comprehensive Implementation Guide—2003* (issued in May 2003). We also revised the Guides:

- To reflect the issuance of the new AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, which contains the guidance on audits in accordance with *Government Auditing Standards* (1994 edition, as amended) and U.S. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, that previously was in Statement of Position (SOP) 98-3 of the same name as the new Guide. (See the discussion of the new Guide in this section of this Alert titled “Issuance of New AICPA Audit Guide for Performing OMB Circular A-133 Audits.”)
- To add a new auditor’s report to the GASB 34 Audit Guide to illustrate a situation with multiple opinion modifications, including an adverse opinion when a major fund is not included in the financial statements.
- To add a new appendix to the GASB 34 Audit Guide that provides an expanded contents listing, including all headings, tables, and examples, in alphabetical order, by chapter, to help users locate topics of choice.

Help Desk—For copies of the *Non-GASB 34 Audit Guide* (product no. 012563kk) and the *GASB 34 Audit Guide* (product no. 012663kk) (both with conforming changes through May 1, 2003), call AICPA Member Services at (888) 777-7077 to order your copy. Also see the “References for Additional Guidance” section later in this Alert.

Health Care Organizations

.45 The Audit and Accounting Guide *Health Care Organizations*, has been updated with conforming changes as of January 1, 2003, to reflect the issuance of GASB Statement No. 34 and related pronouncements. Because they are not yet effective for certain governmental health care entities, the provisions of GASB Statement No. 34 and related pronouncements concerning governmental health care entities that are included in the scope of the Guide are discussed in a new Appendix F to the Guide. Illustrative management’s discussion and analysis, basic financial statements, and notes to financial statements prepared in conformity with GASB Statement No. 34 and related pronouncements are also provided in the new Appendix F to the Guide.

Help Desk—For copies of the *Health Care Organizations* Guide, contact Member Services at (888) 777-7077 and ask for product number 012613kk.

Effect of Adopting GASB Statement No. 34 on Auditors’ Reports

.46 The adoption of GASB Statement No. 34 constitutes a change in accounting principles that, unless immaterial, will require the auditor’s report to include an explanatory paragraph regarding consistency. Such a paragraph could read “As described in Note X, the City has implemented a new financial reporting model as required by the provisions of GASB Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*, as of June 30, 20X1.”

AICPA Issues Three Practice Aids Relevant to State and Local Governments

Auditing Governmental Financial Statements: Programs and Other Practice Aids

.47 This Practice Aid (scheduled for issuance in fall 2003) is a nonauthoritative companion to the AICPA Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*, and will address GAAS audits of financial statements prepared in conformity with GASB Statement No. 34. Organized using the same sequencing as the GASB 34 Guide, this publication will primarily comprise illustrative audit programs and other practice aids, such as an engagement letter, a management representation letter, and deposit and investment confirmations. The Practice Aid also will have a case study on selecting, evaluating the results of, and reporting on opinion units.

Help Desk—Watch future issues of the CPA Letter for the status of this upcoming Practice Aid. You can also periodically check the CPA2Biz Web site at www.cpa2biz.com.

Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide

.48 With fraud appearing so frequently in recent news about corporate, employee, and even auditor misdeeds, the AICPA has issued this nonauthoritative guidance to provide CPAs with information related to implementing SAS No. 99. Topics relate to a full spectrum of fraud-related matters, including, for example, understanding SAS No. 99 and its implications and computer-assisted audit techniques. The Practice Aid also features industry-specific conditions, including those in a state and local governmental environment that may indicate the presence of fraud.

Help Desk—You can obtain this convenient reference by contacting AICPA Member Services at (888) 777-7077 and asking for product no. 006613kk.

Applying OCBOA in State and Local Governmental Financial Statements

.49 A significant number of the more than 87,000 state and local governments prepare their financial statements using an other comprehensive basis of accounting (OCBOA), as defined in SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04). With issuance of GASB Statement No. 34, questions have developed regarding the applicability of those financial reporting requirements to OCBOA financial statements. This nonauthoritative Practice Aid provides guidance in preparing OCBOA financial statements of state and local governments and also for the appropriate auditor reporting on those financial statements in accordance with SAS No. 62 and the AICPA Audit and Accounting Guide *Audits of State and Local Governments* (GASB 34 Edition).

Help Desk—You can obtain this convenient reference (expected to be published by the end of August) by contacting AICPA Member Services at (888) 777-7077 and asking for product no. 006614kk. For additional guidance on both preparing and auditor reporting on OCBOA financial statements, also check SAS No. 62 and chapter 15 of the AICPA Audit and Accounting Guide *Audits of State and Local Governments* (GASB 34 Edition).

Issuance of New AICPA Audit Guide for Performing OMB Circular A-133 Audits

.50 This new Audit Guide titled *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, is the former Statement of Position (SOP) 98-3 of the same name. Until this year, that guidance had been included as an SOP in an appendix to both the GASB 34 and non-GASB 34 editions of the AICPA's state and local government Audit and Accounting Guides and in the not-for-profit organizations Audit and Accounting Guide. The AICPA ASB decided to convert the SOP into an AICPA Audit Guide because the content and guidance in the SOP are more similar to that which would be included in an Audit Guide and also to make it more clear that, like other AICPA Audit Guides, it is updated each year for conforming changes. The new Guide does not supersede the guidance that appeared in SOP 98-3 but rather changes its format from an SOP to an Audit Guide. It is now one of the AICPA's primary sources of authoritative guidance for performing audits under the Single Audit Act Amendments of 1996; OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*; and *Government Auditing Standards* (see the discussion in the following section regarding a new related nonauthoritative Audit Risk Alert).

.51 Under SAS No. 95, this Audit Guide is considered an Interpretive Publication. Interpretive Publications are recommendations on the application of SASs in specific circumstances, including engagements for entities in specialized industries. If you do not apply the auditing guidance included in an applicable Interpretive Publication, you should be prepared to explain how you complied with the SAS provisions addressed by such auditing.

.52 Each year since 1998, AICPA staff has updated the SOP and, in its new form as a separate guide, this year is no different. Updates for this Guide include conforming changes related to recent auditing standards through SAS No. 101, *Auditing Fair Value Measurements and Disclosures*, and other changes in guidance, for example, changes resulting from recently adopted Amendment No. 3, "Independence," to *Government Auditing Standards* and the AICPA's Audit and Accounting Guide *Audits of State and Local Governments* (GASB 34 Edition).

Help Desk—The product number for the new Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* is 012743kk. To place your order for this Guide, you can call AICPA Member Services at (888) 777-7077. Also see the "References for Additional Guidance" section later in this Alert.

Single Audit Risk Alert

.53 You may have grown accustomed in previous years to looking to this Audit Risk Alert, as well as the Alert on not-for-profit organizations (NPOs), for the latest developments on audits of federal awards (also known as single audits or Circular A-133 audits). This is the first year that such guidance will not be included in this Alert and the NPO Alert. Instead, because of the importance of this topic, the guidance will be included in the separate annual Audit Risk Alert, titled *Single Audits* [AAM section 8220]. The Single Audit Alert will provide auditors of organizations receiving federal awards with an overview of recent industry, regulatory, and professional developments that may affect the audits they perform. If you perform single audits, you should consider obtaining a copy of the Single Audit Alert. Also note that this State and Local Governmental Alert will continue to provide updates on Government Auditing Standards as many audits of state and local government financial statements are required to be performed under those standards, regardless of whether the entity receives federal money (see the discussion later in this section on *Government Auditing Standards* developments).

Help Desk—The product number for the Audit Risk Alert, *Single Audits—2003* [AAM section 8220] is 022453kk. To place your order for the Alert, you can call the AICPA at (888) 777-7077. Also see the "References for Additional Guidance" section later in this Alert.

AICPA Ethics-Related Standards

Revision of Interpretation 101-10

.54 Ethics Interpretation No. 101-10, "The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12), discusses the effect on an auditor's independence of relationships with entities included in governmental financial statements. The AICPA issued a revision of this interpretation (effective March 2003) that reflects new wording related to changes resulting from issuance of GASB Statement No. 34. In addition, certain changes were made to the Interpretation to conform it to the AICPA's new independence rules that were issued in November 2001 (that is, engagement-team focused approach to independence). Finally, the revision changes the focus of the Interpretation, which had been based on the commercial model concept of *financial control* to an *accountability* focus, which is more consistent with the government reporting model.

Help Desk—You can find the revision to the Interpretation in the March 2003 issue of the AICPA's *Journal of Accountancy*. You can access the *Journal's* Web site at www.aicpa.org/pubs/jofa/joahome.htm.

Revisions to Rule 101—Independence for Nonattest Services

.55 In June 2003, the AICPA's Professional Ethics Executive Committee issued revisions to Interpretation No. 101-3, "Performance of Other Services," of ET section 101, *Independence* (AICPA, *Professional Standards*,

vol. 2, ET sec. 101.05), and deleted Interpretation No. 101-13, “Extended Audit Services,” of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.15), and related Ethics Rulings. In the area of nonattest services, the Committee adopted several new requirements, including those that would require members to:

- Comply with regulations of certain regulatory bodies (such as the state boards of accountancy, the SEC, and the GAO) when performing services for attest clients that are governed by such regulators’ independence rules
- Assess the client’s willingness and ability to oversee permitted nonattest services
- Document various aspects of the permitted nonattest services engagement prior to performing nonattest services

In addition, the committee adopted more restrictive rules for certain services:

- Performing appraisal, valuation, and actuarial services would impair independence if the results of the service will be material to the client’s financial statements and if the services involve a significant degree of subjectivity.
- Performing certain financial information systems design and implementation services would impair independence in certain circumstances.

.56 The committee also clarified existing rules for bookkeeping and internal audit assistance services and proposed an increase in the allowable balance that individuals subject to independence restrictions could have through credit cards and cash advance accounts.

.57 The rule revisions will become effective on September 30, 2003.

Help Desk—To access related information, go to the AICPA Web site at www.aicpa.org/members/ethics.

Government Auditing Standards Developments

.58 Certain laws, regulations, and contracts require auditors to follow *Government Auditing Standards* (also known as the Yellow Book) promulgated by the Comptroller General of the United States. For example, some states require that all local governments’ financial statements be audited in accordance with GAAS and *Government Auditing Standards*. If you are performing a financial statement audit of a state or local government under *Government Auditing Standards*, you should be aware of a number of recent revisions that have been made to the standards.

Independence

.59 In a GAAS audit, auditors must comply with the AICPA’s independence rules included in the AICPA Code of Professional Conduct. For audits performed under *Government Auditing Standards*, auditors and audit organizations are subject to additional independence rules that are in some cases very similar to the AICPA independence rules and in other cases are more restrictive. Amendment No. 3, *Independence*, to *Government Auditing Standards* establishes the additional independence rules under *Government Auditing Standards*. The GAO also has issued a question and answer document titled *Answers to Independence Standard Questions*, which responds to questions related to the independence standard’s implementation time frame, underlying concepts, and application in specific nonaudit circumstances. Amendment No. 3, as affected by *Government Auditing Standards: Answers to Independence Questions*, revises the independence standards in *Government Auditing Standards* for audits for periods beginning on or after January 1, 2003, with early implementation encouraged. The independence rules in *Government Auditing Standards* address when auditors and their organizations are independent from the organizations they audit by defining when personal, external, and organizational impairments to independence exist. If an audit organization is not

independent, *Government Auditing Standards* states that the auditor should (1) decline to perform the work or (2) report the impairment in the scope section of the auditor's report when a government auditor cannot decline to perform the work because of a legislative requirement or for other reasons.

.60 *Government Auditing Standards* adopts an engagement-team focused approach to independence for matters such as financial interests of an individual auditor, not unlike the AICPA's Code of Professional Conduct. It also provides criteria for when governmental audit organizations are organizationally independent from the audited entity for purposes of external and internal reporting. *Government Auditing Standards* employs a principles-based approach to independence supplemented with certain safeguards for matters such as the performance of nonaudit services. With respect to nonaudit services, the *Government Auditing Standards* rules are generally more restrictive than the AICPA rules (see the discussion of recent proposed revisions to the AICPA rules in the section of this Alert titled "AICPA Ethics-Related Standards"). In planning the audit, the auditor should consider the effects of any nonaudit services performed on the auditor's independence for current, future, and planned audit services.

.61 To comply with the provisions governing nonaudit services, audit organizations must meet two overarching principles. The first bars audit organizations from performing management functions or making management decisions for their clients; the second prohibits audit organizations from auditing their own work or providing nonaudit services when the services are material or significant to the subject matter of the audit. If a nonaudit service does not conflict with either principle, an audit organization may perform the service as long as it complies with each of the following safeguards (see paragraph 3.25 of *Government Auditing Standards* for a more detailed description of the safeguards):

- Personnel providing the nonaudit service cannot plan, conduct, or review audit work related to the nonaudit service. Audit and nonaudit work must be performed by separate engagement teams. (When an audit organization provides 40 or fewer hours of nonaudit services related to a specific audit engagement, this safeguard requiring separate engagement teams is waived but the auditors must observe the two overarching principles and other safeguards described in this paragraph.)
- The scope and extent of audit work cannot be reduced beyond the level that would be appropriate if the nonaudit work were performed by an unrelated party.
- The audit organization should document its consideration of the nonaudit service, including its rationale that providing the service does not violate the two overarching principles.
- The audit organization should establish and document an understanding with management regarding the objectives, scope of work, and deliverables of the nonaudit service, including an understanding that management is responsible for the results of the service.
- The audit organization's quality control system should include policies and procedures that ensure consideration of the effect of the nonaudit service on ongoing, planned, and future audits.
- Where a nonaudit service is deemed to conflict with the audit (because the service violates one or both of the overarching principles), the audit organization should communicate to management—before beginning the nonaudit service engagement—that it will be unable to perform subsequent audit work related to the subject matter of the nonaudit service.
- For audits selected during peer review, the audit organization should identify to its peer reviewer all related nonaudit services and provide all related audit documentation.

.62 *Government Auditing Standards* describe both nonaudit services that are expressly prohibited and others that are permissible (as long as the auditor complies with the two overarching principles and all required safeguards noted above). The standards also state that audit organizations can perform routine activities for the audited entity and management without impairing their independence—provided the audit organization neither makes management decisions nor performs management functions. Such ordinary services do not violate the overarching principles and are not subject to the safeguards.

Overhaul to Remaining Sections of Government Auditing Standards

.63 Other changes are in the works for *Government Auditing Standards*. The GAO issued a comprehensive revision to *Government Auditing Standards* on June 25, 2003. This is the fourth revision of the overall standards since they were first issued in 1972. This revision of the standards supersedes the 1994 revision, including Amendments No. 1 through No. 3 (note that the content of these Amendments was incorporated into the revision).

.64 The revision affects all chapters of the Yellow Book, including those relating to both financial and performance audits. Among other things, the proposed changes are intended to clarify the types of audits and services that are performed under the Yellow Book, strengthen and streamline certain provisions of it, and improve understandability of the standards. The revisions are effective for financial audits and attestation engagements of periods ending on or after January 1, 2004, and for performance audits beginning on or after January 1, 2004. Early application is permissible. Some of the more significant changes are that the revision:

- Adds a new chapter on attestation engagements that includes additional field work and reporting standards over and above what would be required under the AICPA's attestation standards.
- Requires that auditors collectively possess the technical knowledge, skills, and experience necessary to be competent for the type of work being performed before beginning the work on the assignment.
- Clarifies that the 80 hours of continuing professional education and training that is required under the Yellow Book every two years should directly enhance the auditor's professional proficiency to perform audits and/or attestation engagements. During the next year, the GAO is expected to modify its existing *Interpretation of Continuing Education and Training Requirements—Government Auditing Standards* (see the related discussion in the section of this Alert titled "References for Additional Guidance") to more specifically address this new clarification and whether certain courses (for example, those related to taxation) would count toward the 80-hour requirement.
- For financial statement audits, adds a requirement for auditors to be alert to situations or transactions that could indicate abuse, and if indications of abuse exist that could significantly affect the financial statement amounts or other financial data, to apply audit procedures specifically directed to ascertain whether abuse has occurred and the effect on the financial statement amounts or other financial data.

Help Desk—You can obtain the new 2003 version of *Government Auditing Standards* (which includes the independence requirements from Amendment No. 3), the independence question and answer document, and a summary of the significant changes made since the 1994 revision of the standards from the GAO Web site at www.gao.gov/govaud/ybk01.htm.

Common Engagement Deficiencies

.65 Following are some common deficiencies noted on governmental financial statement audits found during recent peer reviews and AICPA Professional Ethics Division investigations of CPA firms. This list continues to include some of the deficiencies identified in past Alerts, indicating problems with the same matters. You should consider reviewing your firm's policies and procedures to see whether your governmental engagements also might have these kinds of issues.

- The auditor used inadequate or outdated reference materials related to the engagement performed.
- GAAP requirements for the classification, accounting, and reporting for particular funds and for disclosures were not followed.
- In some cases the auditor's report was not qualified for GAAP departures.
- The auditor's consideration of the entity's internal control was inadequately documented.

- *Government Auditing Standards'* continuing professional education and audit documentation requirements were not met.
- The required *Government Auditing Standards* reports for internal control or compliance were not prepared or were not referred to in the report on the financial statements.
- The auditor failed to document the subsequent events review.
- The management representation letter did not follow the requirements of SAS No. 85, *Management Representations*, as amended.

Accounting Issues and Developments

GASB Pronouncements, Exposure Drafts, and Additional Projects

GASB Pronouncements on the New Financial Reporting Model

.66 In the past few years, the GASB issued the following pronouncements to develop a new financial reporting model for state and local governments:

- GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. This is the “core” reporting model standard, which requires both government-wide and fund financial statements. (The GASB staff has issued implementation guidance relating to this Statement, which, as discussed later in this section, has now been updated.)
- GASB Statement No. 35, *Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities*. This Statement extends the applicability of GASB Statement No. 34 to public colleges and universities.
- GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*. This Statement amends GASB Statement No. 21, *Accounting for Escheat Property*, and clarifies and modifies certain provisions of GASB Statement No. 34.
- GASB Statement No. 38, *Certain Financial Statement Note Disclosures*. This Statement adds several new disclosures to governmental financial statements.
- GASB Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*. This Interpretation clarifies the modified accrual recognition of certain liabilities and expenditures.

Those reporting model standards started to become effective in 2002. The second phase of implementation—for “medium-sized governments”—takes place for 2003 fiscal year ends but only those with year ends after June 15—a phase two government with a May 31 fiscal year, for example, would implement for May 31, 2004. Even when not yet required, many governments are early implementing the new standards. It is important for you to have a solid working knowledge of those standards. You should consult the 2002 Audit Risk Alert *State and Local Governmental Developments* for a thorough briefing on those standards, including their effective dates. In addition, be sure to review the original pronouncements for a complete understanding of their provisions.

Help Desk—The AICPA continues to make available its Practice Aid *Understanding and Implementing GASB's New Financial Reporting Model: A Question and Answer Guide for Preparers and Auditors of State and Local Governmental Financial Statements* (product no. 022516kk). That Practice Aid will help you and the governments you audit understand the new standards. Call AICPA Member Services at (888) 777-7077 to order your copy.

GASB Statement No. 39

.67 In May 2002, the GASB issued Statement No. 39, *Determining Whether Certain Organizations Are Component Units—An Amendment of GASB Statement No. 14*. The Statement is effective for financial statements

for periods beginning after June 15, 2003, with earlier application encouraged. GASB Statement No. 39 provides guidance to determine whether certain organizations for which the primary government is not financially accountable should be reported as component units based on the nature and significance of their relationship with the primary government. Consult the 2002 Audit Risk Alert *State and Local Governmental Developments* for a thorough briefing on GASB Statement No. 39.

.68 GASB Statement No. 39, paragraph 5, adds paragraph 40(a) to GASB Statement No. 14, *The Financial Reporting Entity*, to provide three criteria that a legally separate, tax-exempt organization should meet to be included as a component unit of a reporting entity. The third criterion is “The economic resources received or held by an *individual organization* that the specific primary government, or its component units, is entitled to, or has the ability to otherwise access, are significant to that primary government.” We have observed a potential practice problem with that criterion—some governments mistakenly believe that GASB Statement No. 39 now provides that “significance” is a criterion for including any component unit. Instead, the “significance” criterion results from the GASB’s expanded development of the provisions of GASB Statement No. 14, paragraph 40. Paragraph 40 requires organizations to be included in a reporting entity when the nature and significance of the organization’s relationship with the primary government are such that exclusion would cause the reporting entity’s financial statements to be misleading or incomplete. The “significance” criterion in new paragraph 40(a) applies only to the legally separate, tax-exempt organizations that meet the other two criteria in that paragraph. As discussed in paragraph 30 of the Basis for Conclusions of GASB Statement No. 39, “significance” constitutes a higher threshold for inclusion than is provided for component units that meet GASB Statement No. 14’s financial accountability criterion. Governments should continue to include component units for which they are financially accountable in their financial reporting entity based on materiality, not significance.

GASB Statement No. 40

.69 In March 2003, the GASB issued its Statement No. 40, *Deposit and Investment Risk Disclosures, an amendment of GASB Statement No. 3*. The Statement requires specific disclosures for credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. It also modifies GASB Statement No. 3, *Deposits with Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements*, in part, to limit the required disclosure of custodial credit risk to “category 3” deposits and investments. GASB Statement No. 40 is effective for financial statements for periods beginning after June 15, 2004, with earlier application encouraged.

GASB Statement No. 41

.70 Issued in May 2003, GASB Statement No. 41, *Budgetary Comparison Schedule—Perspective Differences*, clarifies the requirements in GASB Statement No. 34 for reporting budgetary comparison information. The statement applies to governments with budgetary structures (certain program-based budgets, for example) that prevent them from presenting budgetary comparison information for their general and major special revenue funds, as required by GASB Statement No. 34. GASB Statement No. 41 requires those governments to present budgetary comparison schedules as required supplementary information (RSI) based on the fund, organization, or program structure that it uses for its legally adopted budgets. Those presentations may not be displayed as basic financial statements. GASB Statement No. 41 is effective simultaneously with GASB Statement No. 34. For governments that already have implemented GASB Statement No. 34, the Statement is effective immediately—for periods beginning after June 15, 2002.

GASB Exposure Drafts of Proposed Statements

.71 The GASB has these outstanding exposure drafts (EDs) of proposed Statements that it plans to finalize before the end of 2003:

- *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*. This ED proposes accounting and reporting guidance for (1) recognizing losses and for writing off a portion

of historical cost for the impairment of capital assets and (2) all insurance recoveries (not just those associated with impairment of capital assets). Its proposed effective date is for financial statements for periods beginning after December 15, 2004, with earlier application encouraged.

- *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* and the related *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. These EDs propose standards for how employers and plans should report postemployment health care, as well as other forms of postemployment benefits (for example, life insurance) when provided separately from a pension plan. The GASB also issued a companion plain language supplement to these EDs, *Other Postemployment Benefits*. The GASB proposed that the employer ED become effective in three annual phases (using the same dollar cutoffs as was done with GASB Statement No. 34) starting for periods beginning after June 15, 2006. The GASB proposed that the plan ED become effective one year before the effective date of the related Statement for the employer in single-employer plans or for the largest participating employer in multiple-employer plans. For both EDs, earlier application would be encouraged.

GASB Technical Bulletin

.72 In June 2003, the GASB staff issued Technical Bulletin (TB) 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*, to supersede GASB Technical Bulletin No. 94-1, *Disclosures about Derivatives and Similar Debt and Investment Transactions*. The TB applies to derivatives that are not reported at fair value on the statement of net assets. It provides an updated definition of derivatives and also provides disclosure requirements for the government's objective for entering into the derivative and the derivative's terms, fair value, associated debt, and risk exposures. The TB also discusses acceptable methods for determining fair value. It is effective for financial statements for periods ending after June 15, 2003, with earlier application encouraged.

Comprehensive Implementation Guide

.73 The GASB staff issued the *Comprehensive Implementation Guide—2003* in May 2003. The guide combines the staff's previous eight implementation guides and revises their content for new pronouncements, especially GASB Statement No. 34 and its related pronouncements, that changed answers to certain questions and/or made the questions moot. Some new questions, not addressed in the original guides, have also been answered. The GASB staff plans to update the *Comprehensive Implementation Guide* annually.

Additional GASB Projects and Publications

.74 GASB projects that may see EDs of proposed accounting and financial reporting standards released in the remainder of 2003 and in 2004 include (1) derivatives and hedging, (2) certain economic condition reporting issues (primarily relating to statistical information), (3) pollution remediation obligations, and (4) net assets/fund balance. EDs of proposed TBs are also expected on termination benefits and tobacco settlement issues.

.75 The GASB also has identified several financial reporting issues as potential long-term research and monitoring projects: (1) additional economic condition reporting issues, (2) fiduciary responsibilities, (3) service efforts and accomplishments (performance measurement), (4) the preservation method for infrastructure assets, and (5) electronic financial reporting.

.76 In July 2002, the GASB issued *Report on the GASB Citizen Discussion Groups on Performance Reporting*. That research report, funded by a grant from the Sloan Foundation, summarizes the results of meetings held to obtain information about users' experiences with, and perceptions of, performance measures.

Help Desk—If you are interested in tracking the progress of the GASB's projects, look at the GASB Web site at www.gasb.org. You can obtain a free copy of the research report from the GASB through its Web site.

GASB Statement No. 34 Implementation Issues

.77 Although implementing GASB Statement No. 34 and its related pronouncements can be challenging, many preparers found the process less difficult than they expected, provided they gave it appropriate planning and research. One important step is to learn from the experience of others. Following are some of the difficulties we have noted in the implementation process, including a reference to the GASB standard that provides guidance, where applicable:

- The MD&A contains subjective language or discussions that go beyond the required topics (GASB Statement No. 34, paragraph 4 and paragraph 11, as amended by GASB Statement No. 37, paragraph 4).
- The fund level discussion in MD&A focuses on totals of fund types rather than individual funds (GASB Statement No. 34, paragraph 11(d)).
- The MD&A does not address both years presented in two-year comparative financial statements (GASB *Comprehensive Implementation Guide—2003*, item 7.14).
- Special purpose governments mistakenly believe they are not required to present an MD&A (GASB Statement No. 34, paragraphs 135 through 141).
- Restricted assets and restricted net assets are not appropriately determined. Specifically, governing board resolutions and annual appropriations bills do not create restrictions (GASB Statement No. 34, paragraph 34).
- Some governments have not developed a separate definition of *available* for governmental fund recognition that is appropriate to the timing of cash receipts for their expenditure-driven grant revenues. (Note that GASB standards do not require the same “availability” time period for every type of revenue.)
- Fiduciary fund financial statements present individual funds rather than fund types (GASB 34, paragraph 106).
- Some hospitals, utilities, and other business-type activities are continuing to use financial statement presentations that are similar to those used by their private-sector counterparts, rather than those required by GASB Statement No. 34 (GASB Statement No. 34, paragraphs 95 through 105).
- Some governments are finding that they have misapplied accounting and financial reporting principles unrelated to GASB Statement No. 34 in the past.
- Note disclosures do not focus on governmental activities, business-type activities, major funds, and nonmajor funds in the aggregate (GASB Statement No. 34, paragraph 113).
- Segment disclosures include activities that do not meet the definition of *segments* (GASB 34, paragraph 122, as amended by GASB Statement No. 37, paragraph 17).
- When the budgetary comparison schedules are presented as required supplementary information (RSI), some governments make related disclosures in the notes to the financial statements rather than in the notes to RSI (GASB Statement No. 34, paragraph 131, as amended by GASB Statement No. 37, paragraph 19).

.78 We also have received numerous questions, often referred to us by the GASB staff, asking whether GAAP-based fund and departmental financial statements are required to include an MD&A. Neither GASB standards, which do not address such financial statements, nor the AICPA Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*, which addresses only auditor reporting on those presentations, directly answer this question.

.79 Long-established practice for presenting GAAP-based fund and departmental financial statements dictates that those presentations should apply all relevant GAAP standards. For example, a GAAP-based

fund financial statement includes relevant GAAP-required note disclosures. GASB Statement No. 34 requires the presentation of an MD&A. That is a GAAP standard. To us, it logically follows that GAAP-based fund and departmental financial statements should present an MD&A, presenting the topics in GASB Statement No. 34, paragraph 11, that are relevant to the presentation.

References for Additional Guidance

AICPA

Web Site

.80 AICPA Online (www.aicpa.org) is the AICPA's Web site on the Internet. The site offers users the opportunity to stay abreast of developments in accounting, auditing, and professional ethics. Online resources include professional news, membership information, state and federal legislative updates, AICPA press releases, speeches, exposure drafts, and a list of links to other accounting- and finance-related sites. The AICPA Web site also features a "Talk to Us" section, allowing users to send e-mail messages directly to AICPA representatives or teams. The AICPA Web site includes a separate section that deals with Circular A-133 audit issues, including a document that provides unofficial answers to frequently asked questions, at www.aicpa.org/belt/a133main.htm.

Order Department (Customer Service Center)

.81 To order AICPA products, call the Customer Service Center at (888) 777-7077 or fax to (800) 362-5066. 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., Eastern Standard Time. Also, visit the CPA2Biz Web site at www.cpa2biz.com to obtain product information and place online orders.

Publications

.82 The following AICPA publications may be of interest to auditors of state and local governments.

- Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)* (product no. 012563kk)
- Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)* (product no. 012663kk)
- Audit and Accounting Guide *Health Care Organizations* (product no. 012613kk)
- Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* (product no. 012673kk)
- SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising* (product no. 014887kk)—This SOP is an appendix to the two Audit and Accounting Guides for state and local governments (see previous bullets) and the Audit and Accounting Guide *Not-for-Profit Organizations* (product no. 012643kk). The SOP also is included in *AICPA Technical Practice Aids* (product no. 005142kk).
- *Understanding and Implementing GASB's New Financial Reporting Model: A Question and Answer Guide for Preparers and Auditors of State and Local Governmental Financial Statements, Revised Edition* (product no. 022516kk)—This publication provides a summary of the significant portions of GASB Statement No. 34 and related GASB publications in a question-and-answer format.
- *Checklists and Illustrative Financial Statements for State and Local Governments (Non-GASB 34 Edition and GASB 34 Edition)* (product no. 009033kk)—Updated annually, this publication provides checklists and illustrations of financial statements, note disclosures, and auditors' reports, including reports in accordance with *Government Auditing Standards* and the Single Audit Act Amendments of 1996. Note: This volume includes both the Non-GASB 34 and GASB 34 editions of the checklists in one handy binder.

- *Audit and Accounting Manual* (product no. 005133kk)—Updated annually, this publication has an extensive section of internal control questionnaires and audit programs for audits of governmental entities, including audits in accordance with the Single Audit Act Amendments of 1996.

Continuing Professional Education Courses

.83 The AICPA offers continuing professional education (CPE) in the form of both group-study and self-study courses, and in print and video format.

.84 Group-study courses include the following:

- Advanced Auditing of HUD-Assisted Projects
- Applying A-133 to Nonprofit and Governmental Organizations
- Audits of HUD-Assisted Projects
- Extra-Strength GASB No. 34
- In GASB We Trust: Foundations in Governmental Accounting
- GASB No. 34 Auditing: The Home of the Brave
- GASB No. 34 Implementation: From Here to There
- GASB No. 34 Infrastructure: How in the GASB Are We Going to Do This?
- Governmental Accounting and Auditing Update
- Governmental and Nonprofit Annual Update
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations
- Workpaper Preparation Techniques for Government and Nonprofit Organizations
- The Revised Yellow Book: *Government Auditing Standards*

.85 Self-study courses include the following:

- Advanced Auditing of HUD-Assisted Projects (product no. 730188kk)
- Applying A-133 to Nonprofit and Governmental Organizations (product no. 730198kk)
- Audits of HUD-Assisted Projects (product no. 730293kk)
- Extra-Strength GASB No. 34 (product no. 731760kk)
- In GASB We Trust: Foundations in Governmental Accounting (product no. 731640kk)
- GASB No. 34 Auditing: The Home of the Brave (product no. 731331kk)
- GASB No. 34 Implementation: From Here to There (product no. 731567kk)
- GASB No. 34 Infrastructure: How in the GASB Are We Going to Do This? (product no. 731562kk)
- Governmental Accounting and Auditing Update (product no. 736472kk)
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations (product no. 734406kk)
- Workpaper Preparation Techniques for Government and Nonprofit Organizations (product no. 732631kk)
- The Revised Yellow Book: *Government Auditing Standards* (product no. 736111kk)

.86 The AICPA also offers the following video courses:

- GASB No. 34 Auditing: The Home of the Brave (product no. 187111kk)
- Governmental Accounting and Auditing Update (product no. 186476kk)
- The Revised Yellow Book: *Government Auditing Standards* (product no. 187101kk)
- Applying A-133 to Nonprofit and Governmental Organizations (product no. 187200kk—available fall 2003)

Online CPE

.87 AICPA InfoBytes, offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. Selected as one of *Accounting Today's* top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay \$149 (\$369 nonmembers) for a new subscription and \$119 (\$319 nonmembers) for the annual renewal. Divided into 1- and 2-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. Governmental topics include the Yellow Book, Circular A-133 auditing, GASB Statement No. 34, HUD, industry updates, and other pertinent issues. To register or learn more, visit www.cpa2biz.com/infobytes.

Industry Conference and Training Program

.88 The AICPA will hold its 20th annual National Governmental Accounting and Auditing Update Conference on August 25–27, in Washington, DC, and again on September 21–23, 2003, in Tempe, Arizona. This 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.

.89 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 19–22, in Baltimore, MD. This program is designed for practitioners or accountants, auditors, and other staff in government who want in-depth, hands-on training in government accounting and auditing.

.90 For more information about the conference or the training program, please contact the Customer Service Center at (888) 777-7077 or the Web site for cpa2biz at www.cpa2biz.com.

Accounting and Auditing Technical Hotline

.91 The Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077 or go to the AICPA's Web site at www.aicpa.org.

Ethics Hotline

.92 Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Fax Hotline

.93 The AICPA has a 24-hour fax system that enables interested persons to obtain information that includes, for example, current AICPA comment letters, conference brochures and registration forms, CPE information, AcSEC actions, and legislative news. To access the hotline, dial (201) 938-3787 from a fax machine and follow the voice cues.

Governmental Accounting Standards Board

.94 GASB publications can be obtained by calling the GASB Order Department at (800) 748-0659. Publications are also available by mail (P.O. Box 30784, Hartford, CT 06150, payment by check) or on the GASB's Web site at www.gasb.org.

.95 The GASB offers the following publications and services:

- *Codification of Governmental Accounting and Financial Reporting Standards*. The 2003–2004 edition is as of June 30, 2003 and will be available in the fall of 2003.
- *GASB Original Pronouncements*, as of June 30, 2003. An updated edition as of June 30 each year is issued each fall.
- GASB staff document *Comprehensive Implementation Guide—2003*. This document provides guidance on implementing GASB standards and includes the previous eight implementation guides in one publication. Issued in May 2003, this Guide provides, in a question-and-answer format, relevant and helpful GASB 34 implementation guidance.
- *GASB User Guides*. The GASB has published a series of guides to assist different users of government financial statements to understand what information can be found in financial statements prepared using the provisions of GASB Statement No. 34.²
- *GASB Web Site*—Information about the GASB can be found on its Web site, www.gasb.org. The site links to online resources about GASB Statement No. 34. The “What’s New?” section contains the latest news about the GASB and governmental accounting, as well as calendars of GASB meetings, speaking engagements, constituent events, outstanding due process documents, the current-period technical plan, and other frequently requested materials. Other items include “Facts about GASB”; summaries of all final GASB documents and ordering information; a list of board members, staff, and advisory council members with their e-mail addresses; and a technical inquiry system.
- *Performance Measurement for Government Web Site*—The GASB’s second Web site, located at www.seagov.org, is a clearinghouse for information about the development, use, and reporting of performance measures for governments. The site’s main features include a citizens’ guide and links to government performance indicators, studies, reports, government sites, ongoing projects, and several online discussion groups.
- *Fax Information System*—The GASB has a 24-hour fax system that enables interested persons to obtain information on upcoming meetings, the current-period technical plan, and “Facts about GASB.” To access the system, dial (203) 847-0700, ext. 14, from a fax machine, and follow the voice cues.

General Accounting Office

.96 The GAO home page, on the Internet at www.gao.gov, contains links to the hundreds of reports and testimony to the Congress each year on a variety of subjects, including accounting, budgeting, and financial management. Hard copies of GAO reports and testimony can be obtained from the GAO, P.O. Box 37050, Washington, DC 20013; phone (202) 512-6000; fax (202) 512-6061; or www.gao.gov/cgi-bin/ordtab.pl.

.97 GAO’s Web site is updated daily and also includes Comptroller General decisions and legal opinions; GAO policy documents; and special publications. You may subscribe to GAO daily electronic alerts using the form at www.gao.gov/subtest/subscribe.html.

² The Governmental Accounting Standards Board’s user guides are not authoritative pronouncements under the hierarchy of generally accepted accounting principles for governmental entities as provided in Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Accordance With Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), as amended.

.98 The following publications are available on the GAO Web site at www.gao.gov/govaud/ybk01.htm. The first three publications also are available through the Superintendent of Documents, U.S. Government Printing Office (GPO), P.O. Box 371954, Pittsburgh, PA 15250-7954; phone (202) 512-1800; fax (202) 512-2250; or <http://bookstore.gpo.gov/index.html>.

- *Government Auditing Standards, 2003 Revision*—These standards relate to financial and performance audits of governmental organizations, programs, activities, and functions, and of governmental funds received by contractors, nonprofit organizations, and other nongovernmental organizations. All previous amendments to the previous 1994 Revision of the Yellow Book (that is, Amendments No. 1 through No. 3) have been incorporated into the 2003 Revision. As of the date of this Alert, the 2003 Revision was available electronically only on the GAO Web site. Details on ordering a hard copy print version will be placed on the GAO Web site once the print version is available.
- *Government Auditing Standards: Answers to Independence Questions* responds to questions related to the Yellow Book independence standard's implementation time frame, underlying concepts, and application in specific nonaudit circumstances.
- *Interpretation of Continuing Education and Training Requirements—Government Auditing Standards* establishes specific CPE requirements for auditors working on audits performed in accordance with those standards. This Interpretation guides audit organizations and individual auditors on implementing the CPE requirements by answering the most frequently asked questions from the audit community. As noted in the section of this Alert entitled "Government Auditing Standards Developments," the GAO is expected to revise this Interpretation during the upcoming year.

Government Finance Officers Association

.99 The Government Finance Officers Association (GFOA) can be contacted at 203 North LaSalle Street, Suite 2700, Chicago, IL 60601-1210; phone (312) 977-9700; fax (312) 977-4806; www.gfoa.org. Its publications include:

- *Governmental Accounting, Auditing and Financial Reporting: Using the GASB 34 Model*—This publication, commonly known as the GAAFR or "Blue Book," provides detailed professional guidance on the practical application of the new financial reporting model to state and local governments. The basic text of the GAAFR also is available on CD-ROM. (*The GAAFR Study Guide Outlines and Exercises* and *The GAAFR Self-Study Course* also are available to assist those wishing to use the GAAFR for instructional or self-study purposes.)
- *An Elected Official's Guide to the New Governmental Financial Reporting Model*—This booklet provides a comprehensive overview of the new governmental financial reporting model established by GASB Statement No. 34.
- "General-Purpose Government Checklist for the Certificate of Achievement for Excellence in Financial Reporting Program"—This detailed checklist has been completely revised to reflect GASB Statement No. 34 and is available free of charge on the GFOA Web site.
- *An Elected Official's Guide to Fund Balance*—This booklet provides the nonaccountant with a concise explanation of the meaning of the various components of fund balance and focuses on how to properly interpret the meaning of fund balance in the general fund.
- *An Elected Official's Guide to Auditing*—This booklet provides elected officials, management, and other nonaudit professionals with practical information concerning the audit process for state and local governments, including discussion of annual audits of financial statements; Yellow Book audits; Circular A-133 audits; auditor's reports; managing the financial audit; performance auditing; and internal auditing. (Recently updated.)
- *Model Request for Proposal for Auditing Services (diskette)*—This diskette includes a model request for proposals for auditing services in WordPerfect 6.1 format (recently updated).

- *Evaluating Internal Controls: A Local Government Manager's Guide*—This publication is designed for public managers seeking the practical guidance needed to assume a leadership role in the design, implementation, and maintenance of a comprehensive framework of internal control.
- *An Elected Official's Guide to Internal Controls and Fraud Prevention*—This booklet provides a concise yet comprehensive overview of internal controls and fraud prevention in the public sector. Explanations cover a wide range of topics, including the control environment; accounting systems; control policies and procedures; evaluating internal controls; the causes, cost, and prevention of fraud; common types of fraud; and how management can detect fraud.
- *Accounting Issues and Practices: A Guide for Smaller Governments*—This 12-chapter manual provides “how to” advice on the basic duties of local government finance officials. Sample documents are included throughout.
- *A Guide to Arbitrage Requirements for Governmental Bond Issues and 1994 Supplement*—These two publications present a comprehensive overview of federal arbitrage requirements.
- *Pension Accounting and Reporting; Pension CAFRS: Guidelines for the Preparation of a Public Employee Retirement System Comprehensive Annual Financial Report; 2000 Survey of State and Local Government Employee Retirement Systems—Survey Report; and the PENDAT 2000 Database and User's Manual*—Various publications and other products on the administration of and financial reporting for PERSs.
- *GAAFR Review*—This eight-page subscription newsletter, issued 10 times each year, covers major issues in governmental accounting, auditing, and financial reporting and includes analyses of recent authoritative pronouncements.
- *Recommended Practices for State and Local Governments*—The GFOA's recommended practices identify “best practices” in each of the major disciplines of state and local government finance. They are available free of charge on the GFOA Web site.
- *Financial Indicators Data Base*—The GFOA makes available each year key data extracted from Comprehensive Annual Financial Reports (CAFRs) submitted to its certificate program. Separate data bases are available for counties, general-purpose governments, and school districts.

.100 This Audit Risk Alert replaces *State and Local Governmental Developments—2002*.

.101 The *State and Local Governmental Developments* Audit Risk Alert 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 Audit Risk Alert would also be greatly appreciated. You may e-mail these comments to lgivarz@aicpa.org or write to:

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Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

.102 We also suggest that you review the annual AICPA Audit Risk Alert, *Single Audits—2003 (Audits of Organizations Receiving Federal Awards: Single Audits Performed in Accordance With Office of Management and Budget Circular A-133)* [AAM section 8220] if you have clients that receive federal money. This Alert addresses current issues of relevance to the performance of single audits, including regulatory, legislative, and other developments, among its many topics. Also review the *AICPA Audit Risk Alert*, which is a general update on economic, auditing, accounting, and other professional developments. That publication discusses numerous general audit topics of interest that, although not specifically geared toward an audit of the financial statements of state and local governments, might be relevant to auditors of those financial statements.

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Appendix

The Internet—An Auditor's Research Tool

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 professional news, state CPA society information, IRS activities, software downloads, university research materials, currency exchange rates, stock prices, annual reports, and legislative and regulatory initiatives. Not only are they accessible from the computer, but they are also 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 information, regulations, and documents from federal agencies and departments
- Discuss audit issues with peers
- Communicate with audit clients
- Obtain information from a client's Web site
- Obtain information from 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; we advise caution when you access 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 how to use search engines effectively and efficiently. 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.

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>
American Institute of CPAs: Main page Circular A-133 audit page	www.aicpa.org www.aicpa.org/belt/a133main.htm
Association of Government Accountants	www.agacgfm.org
Department of Education Office of Inspector General	www.ed.gov/offices/OIG
Department of Housing and Urban Development: Office of Inspector General Real Estate Assessment Center	www.hud.gov/oig www.hud.gov/offices/reac
Federal Audit Clearinghouse	http://harvester.census.gov/sac
Federal Aviation Administration, Office of Airports, Passenger Facility Charge Branch	www.faa.gov/arp/530home.htm
Federal Chief Financial Officers Council	www.cfoc.gov
Financial Accounting Standards Board	www.fasb.org

<i>Organization</i>	<i>Web Site Address</i>
FirstGov (the federal government's central online location)	www.firstgov.gov
General Accounting Office: Main page Government Auditing Standards section	www.gao.gov www.gao.gov/govaud/ybk01.htm
General Printing Office Access (with links to search Code of Federal Regulations, Federal Register, and Public Laws)	www.access.gpo.gov/su_docs/index.html
General Services Administration	www.gsa.gov
Government Finance Officers Association	www.gfoa.org
Governmental Accounting Standards Board: Main page Performance Measurement for Government	www.gasb.org www.seagov.org
U.S. House of Representatives	www.house.gov
IGnet (the federal Inspectors General site): Main page Single audit library	www.ignet.gov www.ignet.gov/pande/audit/mains.html
Internal Revenues Service	www.irs.gov
Library of Congress	http://lcweb.loc.gov
Municipal Securities Rulemaking Board	www.msrb.org
National Association of State Auditors, Comptrollers, and Treasurers	www.nasact.org
Office of Management and Budget: Main page Grants management section	www.omb.gov www.omb.gov/grants
Public Company Accounting Oversight Board	www.pcaobus.org
Securities and Exchange Commission	www.sec.gov
U.S. Senate	www.senate.gov
Thomas Legislative Search	http://thomas.loc.gov

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AAM Section 8080

Common Interest Realty Associations Industry Developments—2001/02

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your common interest realty association (CIRA) audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment your clients operate in—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the CIRA industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2001/02* [AAM section 8010] and *Compilation and Review Alert—2001/02* [AAM section 8015].

Current Economic Developments

.03 For a complete overview of the current economic environment in the United States see the AICPA general *Audit Risk Alert—2001/02* [AAM section 8010].

.04 The economy remained weak and uncertain in the third quarter of 2001, hanging between recovery and recession. The U.S. consumer sentiment index plunged to 83.6 in September 2001, its lowest level in nearly eight years. This loss of consumer confidence is significant inasmuch as consumer spending has been a major pillar propping up the economy. The sharp rise in unemployment was a contributing factor to the reduction in consumer confidence. The U.S. unemployment rate soared to a four-year high of 4.9 percent in August 2001.

.05 The September 11, 2001 attack on America injected further agitation and uncertainty into the U.S. economy. The ramifications of that attack and the ensuing war against those responsible for that attack may deepen the economic slowdown and lead to a recession; however at the time of the writing of this Alert the short- and long-term effects of the attack on the economy are uncertain.

.06 Despite the general economic slowdown, the housing market has remained strong, partly due to low mortgage interest rates. Housing continues to be a good investment for families since home values have appreciated at more than twice the rate of consumer price inflation. Home values have increased by an annualized rate of 6.9 percent nationwide in the second quarter of 2001 according to the Federal Home Loan Mortgage Corporation (FreddieMac).

Regulatory Developments

.07 The operations of CIRAs are regulated by the individual states and not by the federal government. However, federal regulations, court cases, IRS revenue rulings, and federal legislation apply to the income

tax treatment of CIRAs. Also, two federal agencies, the Federal Housing Administration (FHA) and the Department of Veterans Affairs, as well as two government sponsored enterprises (GSEs), FreddieMac and the Federal National Mortgage Association (FannieMae), have regulations and underwriting guidelines to guide developers, mortgage lenders, and others in establishing CIRAs as well as in the sales and financing of units. Although compliance with such regulations may not be mandatory, compliance with their guidelines and underwriting requirements facilitates the development, sale, and resale of units within CIRAs. This section discusses recent developments in federal regulations as they relate to CIRAs, including U.S. Department of Housing and Urban Development (HUD) requirements, IRS private letter rulings, and bankruptcy legislation.

HUD Electronic Submission Requirements for Multifamily Programs

What are HUD's electronic submission requirements for multifamily programs, and what are the auditor's related responsibilities?

.08 A number of CIRAs are involved with housing programs administered by the FHA, which is part of HUD. These housing programs promote the development of housing for elderly and low- to moderate-income individuals and families by providing mortgage insurance, rent subsidies, direct loans, and mortgage interest subsidies. CIRAs that are developed under these programs are typically required to adhere to specific program requirements, as well as to submit annual audited financial statements to HUD. Housing cooperatives are the most likely type of CIRA that might be developed under such HUD programs. If your client should comply with HUD requirements, refer to HUD handbooks for guidance on accountant qualifications, financial statement format, disclosure, reporting, and specific program compliance.

Help Desk—To obtain copies of the HUD handbooks, notices, and other documents go to www.hudclips.org where they are available for print or to be viewed. Printed handbooks can be ordered online through the Direct Distribution System or by telephone at (800) 767-7468.

.09 Under the HUD Uniform Financial Reporting Standards, public housing authorities and project owners of HUD-assisted housing, such as public housing, section 8 housing, and multifamily insured housing programs, are required to submit financial information electronically to HUD's financial assessment subsystem (FASS) via a template known as the financial data schedule (FDS). The electronic submissions should be sent to the Real Estate Assessment Center (REAC), which is the HUD national management center created to receive and evaluate electronic submissions.

.10 Also, if your client is involved in a not-for-profit or for-profit multifamily housing program and is receiving financial assistance from HUD, note that the HUD reporting and audit requirements for such programs have recently changed. A revised user guide, *Industry User Guide for the Financial Assessment Subsystem-Multifamily Housing* (FASSUB guide 3.0), as of September 21, 2001 has been issued by REAC and can be obtained at www.hud.gov/offices/reac/products/fass/fassmf_guide.cfm. This revised guide expands the requirement for electronic submissions to include the multifamily housing portfolio and revises the submission process for audited data.

.11 The FAASSUB guide requires auditors to perform the following:

- The auditor is required to compare the electronically submitted FDS information (which essentially includes a trial balance of the financial statements and certain other supplemental information) in the REAC staging database to hard copy of the same information. The REAC database is made up of accurate, credible, and reliable information assessing the condition of HUD's housing portfolio through an Internet-worked database of comprehensive and objective information drawn from existing government systems and from an ongoing program of property inspections, analysis of financial and management reports, resident surveys, and review of residential appraisals. An attestation agreed-upon procedures report should be prepared and submitted to REAC electronically

by the auditor. The attestation agreed-upon procedures engagement should be performed in accordance with chapter 2, “Agreed-Up Upon Procedures Engagements,” of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 201).

Help Desk—Chapter 2 of SSAE No. 10 supersedes SSAE No. 4, *Agreed-Up Upon Procedures Engagements*. HUD revised its guidance on March 6, 2001, to refer to SSAE No. 10. The guidelines on reporting and attestation requirements of Uniform Financial Reporting Standards (UFRS) can be found at www.hud.gov/utilities/intercept.cfm?/offices/reac/pdf/ufrs22801.pdf.

- Hardcopy of the FDS is required to be included with the basic financial statements and reported on by the auditor in accordance with Statement on Auditing Standards (SAS) No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551). Since the FDS information is outside the basic financial statements, auditors should report on it as it relates to the financial statements taken as a whole.

Help Desk—The AICPA provided input into the UFRS guidelines as HUD developed them, particularly on the auditor report templates. A copy of the UFRS guidelines can be obtained from the REAC Web site at www.hud.gov/reac/pdf/fass_ph_guideufrs.pdf. Additional 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 www.hud.gov/reac. Further assistance on the electronic submission requirements is available by contacting the REAC customer service center at (888) 245-4860.

Unique Independent Public Accountant Identifiers

.12 REAC recently instituted a system of “unique independent public accountant identifiers” (UII) to help identify auditors and to enhance the security of its system. For each electronic submission of a multifamily housing project FDS made after February 5, 2001, that has auditor involvement, FASS requires a UII, which is a randomly generated, permanently assigned, five-digit number. Before an auditor may obtain a UII, the auditor must register within HUD secure systems, which requires the involvement of a multifamily housing entity client. Therefore, you should coordinate with one of your multifamily housing entity clients to obtain your UII in advance of when you will need it.

Help Desk—To obtain more information about UIIs and auditor validation of submission of data required when submitting audited financial information to REAC, visit the HUD Web site at www.hud.gov/offices/reac/products/fass/mf_uiaudit.cfm.

Guidelines for Calculating and Retaining Section 236 Excess Income

.13 On July 27, 2001, the HUD Office of Housing issued Notice H 01-7, which supersedes Notice H 00-17. Notice H 01-7 expires July 31, 2002. The HUD Notice applies to all section 236 projects (the typical CIRA would be a housing cooperative) with assistance through the section 236 interest reduction payment program. HUD Notice H 01-7 provides guidelines for implementation of section 216 of the department’s Fiscal Year 2001 Appropriations Act, P.L. 106377. Section 861 of the American Homeownership and Economic Opportunity Act of 2000 amends section 236(g) of the National Housing Act, providing an extension of the authority to retain excess income. It also provides, in relevant part, that any excess income that a project owner has collected and that such owner has not remitted to the Secretary of HUD may be retained by such owner unless the Secretary otherwise provides. Instructions are provided for an owner’s participating in retention of excess income for projects with assistance through the section 236 interest reduction payments program.

.14 Excess income comprises cash collected as rent from residents by the mortgagor, on a unit-by-unit basis, that is higher than the HUD-approved unassisted basic rent. Excess income may be used for any project

purpose, such as project operating shortfalls and repair costs, which are applicable to CIRA clients. Another project use applicable to CIRA clients is increasing deposits to the reserve fund for replacements to a limit necessary to fund the reserve adequately.

Help Desk—For additional guidance, refer to HUD Notice H 01-7 at www.hudclips.org, which contains sections on policy, retaining section 236 excess income, usage of excess income, requesting approval, treatment of excess income previously collected, and reporting requirements.

IRS Rulings and Memorandum

.15 Private letter rulings (PRLs) are written memoranda furnished by the IRS national office in response to taxpayer requests under published annual guidelines. Technical advise memoranda (TAMs) are furnished by the national office of the IRS upon request of a district director or chief appeals officer pursuant to annual review procedures. It is important to note that although such rulings and memoranda cannot be used or cited as precedent, they can be used as guidance if your client encounters a similar situation. The following may affect CIRAs:

- With PLR 2000-51049 and PLR 2001-01036 the IRS is establishing a rulings position that the operation of exercise facilities and health clubs, under certain circumstances, constitutes a related activity for section 501(c)(3) organizations. If your client is a 501(c)(3) organization and houses exercise facilities in its building then you may consider referring to these private letter rulings for possible guidance. This evolving position has attracted criticism from the fitness club industry in a manner similar to the opposition several years ago to travel tours operated by tax-exempt organizations.
- TAM 2000-47-049 was published by the national office. This technical advise memorandum contains an extensive analysis of the treatment for unrelated business income tax (UBIT) purposes of income from the development and sale of land, the provision of municipal-type services such as water and sewer, garbage collection, services to its own buildings and to the private residences within the grounds, and operation of a golf course, tennis courts, and boating facilities by section 501(c)(3) organizations. If your client is in a similar situation, you may consider referring to this TAM for guidance on what constitutes UBIT under Internal Revenue Code (IRC) 512(a)(1).

Help Desk—For more information on unrelated business income tax go to www.irs.gov/bus_info/eo/topicF02.pdf for a written document on the current developments of UBIT which includes the full PLR and TAM discussions and conclusions on the specific issues mentioned above as well as many others.

Bankruptcy Legislation in Washington

.16 According to the Mortgage Bankers Association (MBA), the percentage of mortgages in foreclosure and the number of late mortgage payments being made by homeowners has increased. The MBA's national delinquency survey showed the following second quarter 2001 results:

- The delinquency rate for loans on one- to four-unit residential properties increased to 4.63 percent. This is up 26 basis points from the first quarter 2001.
- The delinquency rate for conventional loans increased 2.93 percent, up 16 points from the first quarter 2001.
- The rates for FHA loans increased to 10.79 percent, up 79 basis points from the first quarter 2001.
- The rates for VA loans increased to 7.63 percent, up 41 basis points from the first quarter 2001.

.17 Moody's Investor Services stated that late payment and bad loan write-off rates rose by over 13 percent from the prior year. Consumer credit quality has not been this dismal since the negative credit cycle

in 1995–1997. The continuing slowing of the U.S. economy, especially in light of the recent economic effects of the September 11, 2001 terrorist attacks, raises the specter of growing defaults and bankruptcies. It should be mentioned, however, that mortgage lenders, the two federal agencies, and the two GSEs have powerful software-driven scripting and mitigation tools and programs that can assist in bringing delinquent borrowers in CIRAs current in their mortgages. You may want to advise your clients of this management tool.

.18 Under the current law, a CIRA generally becomes a secured creditor in a bankruptcy proceeding when an assessment lien is recorded on the property before the owner (debtor) files for bankruptcy. Once the CIRA receives notification of the bankruptcy, the CIRA must stop all collection action such as warning letters, liens, lawsuits, and foreclosures against that owner immediately due to the federal court's "automatic stay" against such actions.

.19 Legislation is currently going on in Washington that would constitute the largest overhaul of the bankruptcy laws in 20 years. The House and the Senate have appointed conferees who will draft a final version of the Bankruptcy Reform Act of 2001 to be sent to the President for signature.

Proposed Changes in the U.S. Bankruptcy Law

.20 The proposed changes in the bankruptcy law provide that when the owner of a condo unit or the shareholder of a coop files for bankruptcy, he or she is not discharged from liability for assessments or other fees that become due and payable after the owner-shareholder files for bankruptcy, provided that the homeowner continues to live in the unit or receives rent payments from a tenant occupying the unit. However, if the owner-shareholder abandons the property and fails to rent out the unit, then the homeowner is not liable for the post-petition assessments. Therefore, in certain situations under the revised bankruptcy law, associations would have the option of proceeding in state court to collect on post-petition debt.

.21 The passing of this law is important to CIRAs because it will make it easier for CIRAs to collect post-petition assessments¹ and carrying charges² from an owner-shareholder who does not relinquish the ownership interest in the unit. Under the current law, collection of such assessments and charges is tied to occupancy or subletting. Some owners-shareholders engage in "under the table" subletting or allow friends and relatives to stay in the unit rent-free, thereby escaping liability for post-petition monthly assessments and charges.

Audit Issues and Developments

Budgets and Budget Analysis

What is important about CIRA budgets and their analysis for this year's CIRA engagements?

.22 Because budgets are the primary basis for assessments or revenue for a CIRA we will revisit the topic of budgets again this year. In effect, budgets are the cornerstone of a CIRA's performance measurement. The budget is a framework that defines the financial parameters in which a CIRA operates. The legal documents creating most CIRAs require that assessments be based on budgets. The budgets of CIRAs are the monetary expression of their goals and objectives and emphasize the stewardship responsibility of their boards of directors as they deliver the three core housing services of all CIRAs: business services, governance services, and community services. According to Financial Accounting Standards Board (FASB) Statement of Financial

¹ Post-petition assessments are the bankrupt owner's proportionate share of the amount of money necessary to pay for the operation, administration, maintenance, and management of the common property and funds for future major repairs and replacements, late charges, and interest incurred after the date the bankruptcy was filed.

² Carrying charges are charged to tenant-shareholders for operating and capital expenditures based on proprietary lease agreements, in cooperative housing corporations (commonly referred to as rent).

Accounting Concepts No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, budgets are used to allocate and control the use of resources. Budgets are also used to obtain resources. For example, budgets are pivotal in establishing levels of dues, taxes, and fees to be imposed.

.23 Budgets are pivotal in assessing actual versus anticipated CIRA operating results. The AICPA Audit and Accounting Guide *Common Interest Realty Associations* (the CIRA Audit Guide) recommends that the auditor consider comparing budgeted amounts with actual amounts as an analytical procedure in the audit of a CIRA. SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), provides guidance on the use of analytical procedures and requires the use of analytical procedures in the planning and overall review stages of all audits.

.24 Most items in a CIRA's budget are fixed, such as monthly mortgage payments, or easily predictable expenses, such as insurance, corporate taxes, real estate taxes, and labor service contracts. Annual budgets are made up of basic costs for repairs and supplies, as well as major repairs or special projects, which usually account for the lion's share of the annual budget. The remainder consists of utilities, water and sewer charges, and fuel, which have become the most unpredictable variables over the past two years, seriously impacting the budgets of CIRAs.

.25 Over the past year we have seen electricity costs increase more than 25 percent beyond budgeted amounts, leaving many CIRAs dipping into budget surpluses from prior years. This year electricity costs are expected to increase by another 15 or 20 percent. The cost of natural gas and home heating oil also increased sharply, rising anywhere ranging from 25 percent to 50 percent during the course of the 2000–2001 winter season. Insurance premiums in general, and for directors and officers liability coverage in particular, also are likely to rise as much as 25 percent over the next two years due to the rising level of claims at the "severity level"—the \$1 million mark or above. In light of the above, your CIRA client should consider including a contingency line item in the annual budget for these expected increases in operating costs.

.26 The events of September 11, 2001 should be a painful reminder that CIRAs located in high-rise buildings may want to consider developing budgets that include the creation of evacuation procedures, drills for such procedures, various types of safety equipment, the purchase of equipment that can facilitate the evacuation of the disabled, and the purchase of insurance that contains adequate amounts of debris removal coverage.

.27 As an auditor of CIRA clients, you should be cognizant that sometimes the budget accompanying the financial statement has expired. As discussed in the CIRA Audit Guide, if expired budget information accompanies the financial statements, this additional information should be treated in accordance with the provisions of SAS No. 29. Ordinarily, such information would not have been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, the auditor would disclaim an opinion on such information. For an example of a disclosure of opinion that would be appropriate in such circumstances, see paragraph 7.22 in the CIRA Audit Guide.

Help Desk—The AICPA's new Audit Guide *Analytical Procedures* (product no. 021069kk) provides great implementation guidance for the use of analytical procedures. It also includes a discussion of your professional responsibilities under SAS No. 56.

.28 Another budgeting area of concern to auditors includes financial reserve studies. If the CIRA has accepted financial reserve study recommendations, auditors should inquire about the professional qualifications of the entity performing the reserve study and whether the CIRA has reconciled these approved financial amounts with the budget to ensure consistency.

.29 How do budgets play a part in performance evaluations? Budgets can help determine if the CIRA is successfully and prudently delivering its three core housing services. Also, budgets can provide CIRA owners who use them with a measure of evaluating both manager and board performance. Performance of

these key CIRA decision makers is a reflection of, among other things, how the association has actually performed relative to achieving its budgetary financial goals. Some of the more important categories for CIRAs to consider when evaluating performance are listed in the table.

Delivery of Core CIRA Housing Services

<i>Business Services</i>	<i>Governance Services</i>	<i>Community Services</i>
1. Measure the variances between budgeted and actual amounts.	1. Measure and compare the costs of various types of dispute resolution: internal CIRA mediation, use of attorneys, and so on.	1. Evaluate the budgeted cost and timeliness of responses to resident communications concerning CIRA operations, and so on.
2. Determine if proper allocations to replacement fund accounts are being met.	2. Ensure that the cost components of the CIRA's annual plan are included in the budget.	2. Determine that the budget contains sufficient funds so that new residents (owners and tenants) can be successfully oriented to living in the CIRA.
3. Monitor budgeted amounts for delinquencies and bad debts by duration, amount, and type.	3. Make sure sufficient funds are budgeted for board, committee, and staff training.	3. Evaluate the budgeted amounts for making sure the CIRA is in compliance with Fair Housing and similar statutes.
4. Make sure that insurance deductibles are included in the budget.	4. Determine that the records of the CIRA accurately reflect board decisions that involve budgeted items.	4. If the CIRA communicates using a Web site, determine if the budget can support ongoing Internet maintenance and security.

Misappropriation of Assets

.30 Fraud is always a concern for CIRAs, whether the embezzlement is large or small. Frauds in CIRAs sometimes involve CIRA board members or CIRA managers. A typical fraud perpetrated by CIRA board members involves the writing of checks to themselves or to related companies—foregoing the second required signature. CIRA managers who commit fraud typically create fictitious vendors and bill the CIRA with invoices from those vendors. The CIRA's payment check is then deposited into the manager's bank account.

.31 Auditors have a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. Fraud often goes undetected and may be concealed through falsified documentation, including forgery. Auditors should be alert to the presence of risk factors or other conditions that may alert the auditor to a possibility that fraud may exist. In planning an audit, the auditor should consider fraud risks factors in accordance with the guidance contained in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). Examples of fraud risk factors and other conditions that may affect CIRAs include the following:

- A lack of segregation of duties among the CIRA board or CIRA management (responsibility for financial matters is largely in the hands of one individual).

- A lack of CIRA board oversight over financial matters, such as a failure to review the CIRA's financial statements periodically.
- Inadequate internal control, such as a failure to prepare and independently review bank reconciliations, independently match checks to authorized invoices or payment requests, and obtain multiple bids for major contracts or projects.
- General ledgers that do not balance or subsidiary accounting records that cannot be reconciled to the general ledger.
- Cash shortages that cannot be explained.
- Accounts receivable credited without proper authorization.

.32 An auditor should assess the risk of material misstatement of the financial statements due to fraud and take into account all identified risk factors and other conditions. 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.

.33 Depending on an auditor's assessment of the risk of material misstatement due to fraud, the following example audit procedures may help detect the existence of fraud.

- Review vendor lists with appropriate board members or management and investigate any material payments to unknown or unusual vendors.
- Review bank statements and cancelled checks. Look for checks for significant amounts made out to cash, employees, or unusual vendors. For those checks, compare endorsements to payee.
- Examine bank reconciliations. A thorough review of bank reconciliations is one of the best ways to detect fraud relating to cash. With the advent of sophisticated software it is possible to forge bank statements; the auditor should examine such statements for the bank's watermark or other security mark.
- Examine material disbursements with management-only signatures carefully.
- Use substantive analytical procedures, including the development of an expected dollar amount, at a high level of precision, to be compared with a recorded amount.

.34 SAS No. 82 provides guidance for the auditor if he or she determines that financial statement misstatements are or may be the result of fraud.

Help Desk—In implementing SAS No. 82, auditors can consult the AICPA's publication entitled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (product no. 008883kk). This publication contains practical user-friendly information to help understand and follow the requirements of SAS No. 82. Call the AICPA at (888) 777-7077 to order.

Audit Efficiency

.35 The AICPA Private Companies Practice Section (PCPS) task force has conducted a survey on the best practices in audits. The not-for-profit (NPO) sector was selected because NPOs often have small operations and few accounting staff, if any, which poses a particular challenge to audit efficiency. However, the best practices uncovered can be applied to CIRA audits as well, since there are many similarities between the two. Firms cited for their excellent quality controls shared practice tips on how to improve audits while saving time and enhancing profits. The study also revealed four important steps to achieving audit efficiency.

.36 As reflected in the survey findings, sometimes less is more when it comes to audit efficiency. While still meeting professional standards, many CPA firms have found it possible to reduce the amount of time involved in the audit. They can improve and maintain quality just by working smarter. The four steps to achieving audit efficiency include:

1. Involve client in audit preparation
2. Retain clients and staff
3. Plan properly
4. Assess risk

Involve Client in Audit Preparation

.37 CPAs can work much more efficiently when clients supply them with all the information they need to perform the audit. If a CPA's staff has to spend time locating and copying needed files or doing catch-up bookkeeping work, the length of the audit most often increases, resulting in the firm not realizing 100 percent of the value of its fees.

.38 The survey revealed a variety of strategies firms are using to ensure clients are prepared for their audits:

- One firm created two separate groups: a traditional audit team and another, "swat" team that prepares clients for the audit. The firm would introduce the swat team, if needed, with a different engagement letter for the additional audit preparation work to be performed, which then forces a conversation with the higher level people. The conversation would include discussion of what's not ready, what needs to happen, how the firm can help, and what it would cost.
- Firms can review possible engagement efficiencies with the clients at the planning conference. Items that added or saved time or money during the previous year's engagement can be discussed, to reinforce the right client behavior and in turn allow the clients to see how they can provide the firm with better assistance and the positive financial impact it will have on the fee.
- Practitioners can meet with the board of directors, and ask them to communicate the value and importance of the audit to the organization staff members and urge them to cooperate in the engagement preparation. Firms can also provide explicit lists of what is needed with clear examples and due dates.
- Some firms have also discounted the fee when proper preparation is performed. They have found that a small inducement can cost less than taking on the preparation work themselves.
- Some firms reschedule the fieldwork if the client is not ready.
- Finally, developing realistic expectations for your clients is yet another strategy to help you ensure your clients are prepared for the audit.

Retain Clients and Staff

.39 According to the firms surveyed, an important contributor to efficiency is a meaningful investment in an industry niche. Greater familiarity with the practice area, such as CIRAs, and with particular clients enables practitioners to streamline their audit approaches and to make the most of the time they spend on each engagement. It also allowed them to offer clients valuable advice on best industry practices and to charge premium fees. One way to keep the relationship going is to bring next year's engagement letter with you when you drop off the reports at the end of the audit. Some clients may sign it and hand it right back to you.

.40 *Strategies for Achieving Low Employee Turnover.* Staff retention was also very important to the participants surveyed. It enhances both their client-specific and industry experience. The best strategies included:

- Explicit and enforced anti-overtime policies
- A growth plan that offers opportunities for recognition and advancement to partner level
- Flexible hours and casual dress policies
- Competitive compensation and benefits
- Keeping the work interesting, which can involve granting responsibility and including staff in the planning process.

Plan Properly

.41 Many practitioners believe that planning is critical to audit efficiency. The time the participants surveyed spent on this part of the audit process varied greatly from firm to firm, with a range of 2 percent to 25 percent.

.42 Strategies to plan properly included:

- Spend time getting to know a client and its systems in advance to help understand its entire operation, as opposed to reviewing or performing a bunch of procedures that were done in the past and not really understanding why.
- As a part of the planning process, review the prior year's workpapers to familiarize the firm with client issues and to seek out possible past inefficiencies and possible improvements in the firm's own work.
- Meet with the client to discuss the audit process and identify client responsibilities. Downloading the client's trial balance to the firm's software, sending confirmations, and preparing lead schedules are all procedures performed in the planning process, as well as reviewing planning decisions with the firm's audit staff and considering the staff suggestions for improvements that were turned in at the end of last year's work.

.43 However, the survey found that not all successful firms have lengthy planning processes. Some considered what the firm could have done differently simply by reviewing the prior year's audit, while others created a final plan after the audit had begun, when current issues and problems were clear. These approaches generally were applied by smaller firms with a higher percentage of experienced staff.

Assess Risk

.44 The survey found that correlating audit efforts to the levels of risk and materiality resulted in a more efficient approach. The practitioner's audit risk assessment will affect the types of procedures to be performed. Procedures in the low-risk areas should be minimal. The firms should focus their procedures on the potential problem areas instead.

.45 *Strategies for Assessing Risk.* When considering risk, it's a good idea to bring the whole audit team together. In doing so, the senior people can talk about industry risks, while the middle-level people tend to know more about the expertise or knowledge base of client personnel and control issues. The lower-level people tend to give little input but learn a lot, thus enabling the whole audit team to understand the different types of risk.

.46 According to the survey analytical procedures (reasonable and predictive tests) were considered to be the most efficient. One firm's audit team begins each step of the process by asking, Can we audit this analytically? Every participant is trying to use more analytical procedures and to do less transaction testing because it:

- Saves time.
- Uncovers what isn't there instead of focusing on what is.
- Is more interesting to perform, leading to a deeper understanding of the client's business.

.47 The survey revealed these areas in which predictive and reasonable tests have replaced transaction testing and saved time:

- Rent payable or paid and rent receivable or received.
- Interest income.
- Depreciation.
- Payroll and payroll taxes.
- Supplies.
- Prepaid expenses (rent, insurance).
- Professional fees.

.48 The auditor considers the level of assurance, if any, he or she wants from substantive testing for a particular audit objective and decides, among other things, which procedure, or combination of procedures, can provide that level of assurance. For some assertions, analytical procedures are effective in providing the appropriate level of assurance. For other assertions, however, analytical procedures may not be as effective or efficient as tests of details in providing the desired level of assurance.

Time Efficiencies

.49 The survey also revealed tips for enhancing efficiency. One step considered key to an efficient audit, saving as much as 20 percent to 30 percent of total time, was completing the audit in the field. Employees are less distracted when the audit wrap-up is completed in the field, including:

- Reviewing workpapers.
- Clearing up points that arise while doing the review of the workpapers.
- Producing the draft report and management letter.

.50 Other efficiencies identified that could improve profitability include:

- Use technology. Cut down on hard copy and use laptops and even portable printers to facilitate efficiency in the field.
- Include memos in the workpapers. These can stipulate test objectives, document steps performed, and describe what's found.
- Organize workpapers along narrative lines. Arrange them so they describe what was done, why, and the results.
- Keep it short. Restrict workpaper files to less than one-inch thickness.
- Keep a summary of information received from the client rather than storing all the data in the files for next year's team to wade through.
- Conduct firmwide meetings on how to streamline workpapers.
- Keep in touch. Have the audit partner or senior manager available to staff in the field to reduce cycle time and total audit time; staff can then get quick answers and implement changes to the audit program.

- Be consistent. Standardize the format and flow of workpapers so they are easy to understand and all data contained in them are readily referenced.

Accounting Issues and Developments

Environmental Remediation Liabilities

.51 Recently, there has been heightened vulnerability to CIRAs with regards to environmental claims. Under current law, a CIRA may be held liable in an environmental claim even if the CIRA was not involved in generating, disposing of, or transporting hazardous substances. If the CIRA owns land that was contaminated by previous owners, the CIRA may still become liable for the cleanup of the site.

.52 In addition to being concerned about environmental issues that it inherits from other parties, a CIRA may have the following environmental considerations:

- *Underground fuel storage tanks.* Heating oil for housing units and gasoline for vehicles may be stored underground at a CIRA. Federal, state, and local regulations require monitoring of those storage tanks for leaks. Also, if leaks occur, the cleanup of the surrounding soil is expensive and only partially covered in typical CIRA insurance policies.
- *Wetlands.* Federal law protecting wetlands may affect a CIRA's ability to make changes to its property when the CIRA is located on or near wetlands.
- *Mold, mildew, and other toxic chemicals.* CIRAs are seeing these "toxic torts" as construction, rehabilitation, and related property maintenance problems grow.
- *Waste disposal practices.* Depending on the types of substances being used and disposed of at a CIRA (for example, fertilizers and paints), regulations exist that are designed to prevent the release of hazardous substances into the environment. These regulations pertain to various matters, including the types of containers in which the wastes are stored, and the land and structures surrounding them.

.53 Statement of Position (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, *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.

.54 Estimates of environmental remediation liabilities usually are predicted on subjective information and numerous judgments about how matters will be resolved in the future. Such matters generally increase audit risk, because of the difficulty in identifying and estimating remediation liabilities.

.55 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.

.56 Auditors should make inquiries of management and other appropriate personnel, have knowledge of the CIRA's operations, make inquiries of the CIRA's attorneys, read the minutes of the board meetings, and examine other pertinent sources of information to obtain an understanding of any potential environmental remediation liabilities present on the engagement. When potential exposure to environmental remediation liabilities exists, the auditor's understanding of the CIRA's internal control generally should extend to controls designed to help management identify and evaluate environmental remediation liabilities and loss contingencies.

.57 The auditor's substantive testing of environmental remediation liabilities generally consists of testing the accounting estimates recorded by management, making inquiries of legal counsel or identified specialists, and obtaining representations from management.

.58 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.

.59 SOP 96-1 applies when there is the probability of litigation. Auditors should consider whether management has followed the guidance set forth in FASB Statement No. 5, FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and the FASB Emerging Issues Task Force (EITF) Issue No. 93-5, *Accounting for Environmental Liabilities*.

.60 EITF Issue No. 93-5 states 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*.

Tax Treatment of Environmental Cleanup Costs

How should CIRAs treat environmental cleanup costs for tax purposes?

.61 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 Revenue Ruling 70-604 for guidance), 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.³

.62 Because of economic performance rules under IRC section 461(h), CIRAs should not deduct the costs associated with environmental cleanup until they are actually paid.

³ In determining the applicability of IRC section 277 to CIRAs, the accountant should refer to applicable court cases and the IRC.

Disclosure of Certain Significant Risks and Uncertainties

What significant risks and uncertainties do auditors need to disclose?

.63 SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires entities to include in their financial statements disclosures about (1) the nature of their operations and (2) the use of estimates in the preparation of the financial statements. In addition, if specified criteria are met, SOP 94-6 requires entities to include in their financial statements disclosures about (1) certain significant estimates and (2) current vulnerability due to certain concentrations.

.64 Examples of estimates that may be particularly sensitive to changes in the current environment that may be presented in the financial statements of a CIRA include the following:

- Liabilities arising from lawsuits filed against the CIRA.
- The collectibility of assessments receivable.
- Liabilities arising from environmental remediation.

.65 Examples of concentrations that may meet the SOP 94-6 criteria for disclosure in a CIRA's financial statement include the following:

- The available sources of supply material, labor, or services.
- The number and amounts of loans obtained from a particular lender.
- The geographic area in which the CIRA is located.

.66 In preparing financial statements in conformity with GAAP, auditors should refer to SOP 94-6 for guidance. Auditors should consider whether all significant estimates and concentrations have been identified and considered for disclosure.

Uninsured Risks

.67 CIRAs may lack sufficient insurance to protect them against significant loss. Although insured, some CIRAs carry deductibles that would cause them to suffer significant losses before receiving insurance compensation. Internet-related exposures such as maintaining privacy and security over information on CIRA Web sites could cause potential liabilities and environmental remediation liabilities (see the "Environmental Remediation Liabilities" section of this Alert). When auditing a CIRA that is exposed to significant uninsured risks, questions concerning the financial statement implications of such uninsured risks arise. Should uninsured risks be accrued for? Is financial statement disclosure of an uninsured risk required?

.68 When addressing these questions, auditors should remember the following points:

- The absence of insurance against risks of future loss or damage to an entity's property by fire, hurricane, wind, explosion, or other similar events does not mean that an asset has been impaired or a liability has been incurred at the date of the entity's financial statements. With respect to events of that type, the condition for accrual is not met prior to the occurrence of the event because until that time there is no diminution in the value of the property.
- The sole result of accrual, for financial accounting and reporting purposes, is allocation of costs among accounting periods. Anticipation of asset impairments, liabilities, or losses that do not relate to the current or a prior period is not justified by the matching concept.
- Generally accepted accounting principles (GAAP) do not require the disclosure of noninsured or underinsured risks; however, those disclosures are not discouraged in appropriate circumstances.

.69 Auditors should refer to FASB Statement No. 5 for further guidance.

Privacy

What is all the talk about privacy issues about?

.70 Protecting the privacy of financial information has emerged as an issue within the CIRA industry. Increasingly, CIRAs are utilizing online application service programs. Services and functions being conducted online include:

- Collecting assessments through Web-enabled financial management software.
- Processing work orders.
- Collecting user fees (for example, paying for the pool pass).
- Collecting rents from commercial users.
- Communicating with homeowners via e-mail.
- Communicating with board members via e-mail.
- Storing and transmitting documents such as governing documents, rules, and regulations.
- Submitting forms to vendors for bids.

.71 When services and functions are conducted online, privacy issues arise. Currently, only a handful of CIRAs conduct the above functions and services on the Internet. Nevertheless, using the Internet for such services will continue to grow since it simplifies and reduces the cost of the transactions, as well as facilitating loan balancing.

Privacy Risk

.72 Concerns over privacy tend to focus on the following points:

- Personal information transmitted over the Internet and other networks
- Third-party access to personal information
- The extensive collection of sensitive, personal information necessary to carry on data mining and customer relationship management activities.

Privacy Regulations and Laws

.73 CIRAs should be aware of existing federal and state privacy regulations and emerging regulations. Privacy is a new and growing concern, and new rules likely will continue to develop. Also, under the federal privacy law, if the Federal Trade Commission determines state laws and regulations provide greater consumer protection, those requirements will be incorporated into the federal requirements. Several states have recently passed or proposed various privacy regulations.

Considerations for Auditors and Business Opportunities

.74 *Auditor Considerations.* As with any significant legal or regulatory requirements, the auditor may need to obtain appropriate representations from management that the CIRA has taken steps to ensure compliance with existing privacy laws and test those representations as considered necessary. Noncompliance could result in significant financial risk to the CIRA.

.75 *Public Practice Opportunities.* Clients may seek advice from CPAs regarding the operational and system requirements related to implementing privacy requirements. In addition, the recent focus on privacy creates numerous service opportunities for the practitioner in his or her role as adviser to clients. As more and

more CIRAs migrate to e-commerce environments, the need for consultative advice and assurance on all aspects of operations affected by these changes becomes paramount to clients and potential clients.

.76 *Providing Assurance on Privacy Systems.* To mitigate risks, CIRAs may seek assurance services that test the efficacy of their privacy systems. AICPA WebTrust™ and SysTrust™ assurance services are pioneering efforts in this area. Privacy consulting—creating both privacy policies and systems as well as internal controls—is also an area where the accounting profession’s expertise can put CPAs front and center in the effort to guard public and business interests.

Electronic Commerce

An extensive discussion about e-commerce.

.77 E-business is an increasingly powerful force affecting the CIRA industry. More and more CIRAs are using the Internet or other computer networks as an information resource or delivery channel. An increasing percentage of CIRAs now provide some form of Web site through which they can communicate with customers, and a small percentage provide Web sites that can be used to conduct financial transactions. These numbers are growing.

.78 The AICPA Audit Risk Alert *E-Business Industry—2001/02* [AAM section 8210] provides an extensive discussion about e-business. The Alert addresses risks associated with e-business, security concerns, advice to help you audit in an e-business environment, testing internal controls, specific professional standards to consult, and skills and training issues. Also addressed in the Alert are accounting considerations including Web site development costs and the costs of start-up activities.

Special Assessments

.79 CIRAs levy 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 therefore should be deferred in accordance with paragraph 4.12 of the AICPA Audit and Accounting Guide *Common Interest Realty Associations* (the Guide) (product no. 012491kk). Auditors should also consider the proper timing and valuation of special assessments receivables, which may be collectible over time.

.80 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.

.81 When auditing assessments receivable, the Guide states that the auditor should design tests to provide reasonable assurance that the following have occurred.

1. All assessments receivable owed to the CIRA at the balance sheet date are recorded.
2. Recorded assessments receivable represent amounts owed to the CIRA at the balance sheet date.
3. Assessments receivable are properly described and classified in the financial statements.

.82 The auditor may achieve these objectives by performing substantive tests or a combination of substantive tests and tests of control. 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 conducted in accordance with generally accepted auditing standards (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.

.83 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.)

.84 It also should be mentioned that as CIRAs age, borrowing from banks has become common practice. The aging structures have resulted in major component deterioration, in areas such as concrete spalling of exterior walls, balconies, garages, and common area structural damages, as well as elevator malfunctioning, and boilers and cooling towers repairs or replacements, just to name a few. Payment terms vary considerably, as banks have been very competitive. Larger CIRAs may even go to banks for working capital loans, with the intention of restoring adequate working capital with higher assessments in a short period of time. However, in light of the current economic conditions, it is conceivable that banks will be more stringent in their underwriting guidelines for CIRA loans.

Update on Accounting Projects That May Be Relevant to CIRAs

.85 Accounting standard setters are addressing several issues that could affect CIRAs. Although final pronouncements may not be issued and effective for some time, you may want to acquaint yourself with how the issues being addressed may change existing practice and affect your CIRA clients. Some clients will require assistance to understand or otherwise prepare for any new accounting guidance.

Special Assessments and Deferred Revenue

.86 Some CIRAs receive loans, such as Small Business Association loans, to pay for common property or other capital improvements. For example, CIRAs may receive loans to pay for replacement of common areas that have been damaged or destroyed by natural disasters, such as earthquakes and hurricanes. In conformity with the CIRA Guide, those improvements are frequently expensed as incurred, rather than capitalized and depreciated. Some of the loans are made to the CIRA subject to the CIRA assessing its members for amounts equal to the present value of the loan obligation, with the assessment generally payable with interest in amounts and in periods matching the loan amortization, although variations on this assessment model exist. A typical scenario is for the lender to require that the loans be secured by the special assessment receivable. Owners agree to the special assessment with the understanding that it is designated for repayment of a loan that is undertaken to finance capital improvements. Questions have arisen about CIRAs reporting special assessments designated for future loan payments in circumstances in which the loans are entered into for purposes of financing capital improvements that are expensed as incurred.

.87 Paragraphs 4.12 to 4.15 of the CIRA Guide discuss, among other matters, accounting for special assessments and deferred revenue. The Guide provides that all assessments, including special assessments

and periodic assessments for funding future major repairs and replacements, should be reported as revenue in the period in which they are assessed, regardless of whether they have been collected or expended, subject to the exception in the following sentence. Paragraph 4.12 of the Guide provides as follows:

Deferred revenue may include items such as special assessments designated for specific costs that have not yet been incurred. Such amounts should be reported as revenues when corresponding *liabilities and expenses* are reported. [*emphasis added*]

In other words, revenue from special assessments designated for specific costs that have not yet been incurred should be deferred and recognized when the corresponding liabilities and expenses are reported.

.88 Practice for reporting the kinds of special assessments described above (assessments for future loan payments in circumstances in which the loans are entered into for purposes of financing capital improvements that are expensed as incurred) is diverse. For example, some recognize the special assessment as a receivable and revenue when the assessment is levied. Others recognize the special assessment as a receivable when levied and recognize revenue when the expenses for making the capital improvements are incurred, which is frequently the same period in which the receivable is recognized and therefore frequently results in the same reporting as that described in the previous sentence. Others do not report the assessment as a receivable (or revenue) when it is levied, but instead report a receivable and revenue each year for the amount of the annual payment due.

.89 In considering whether a special assessment should be reported as a receivable, auditors should consider whether it meets the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements*. Auditors should be alert that a special assessment that has been levied should likely be reported as an assessment receivable even though it is due in future periods, although exceptions could exist depending on the facts and circumstances of a particular assessment. The AICPA is considering whether it should address this issue further, such as through a staff Technical Practice Aid or through a pronouncement issued by the AICPA's Accounting Standards Executive Committee (AcSEC).

Proposed SOP Related to Property, Plant, and Equipment

.90 In July 2001 the AcSEC released for exposure a proposed SOP providing guidance on accounting for certain costs and activities relating to property, plant, and equipment (PP&E). For purposes of this proposed SOP, a project stage or timeline framework is used and PP&E assets are accounted for at a component level. Costs incurred for PP&E are classified into four stages: preliminary, preacquisition, acquisition-or-construction, and in-service. The proposed SOP requires, among other things, the following:

- Preliminary stage costs should be charged to expense as incurred, except for payments to obtain an option to acquire PP&E.
- Preacquisition and acquisition-or-construction stage costs should be charged to expense as incurred unless the costs are directly identifiable with the specific PP&E. Directly identifiable costs include only:
 - Incremental direct costs of activities incurred in transactions with independent third parties for the specific PP&E.
 - Certain costs directly related to specified activities performed by the entity for the specific PP&E.
 - Payments to obtain an option to acquire PP&E.

.91 Costs related to PP&E that are incurred during the in-service stage, including costs of normal, recurring, or periodic repairs and maintenance activities, should be charged to expense as incurred unless the costs are incurred for (1) the acquisition of additional PP&E or components of PP&E or (2) the replacement of existing PP&E or components of PP&E.

- Removal costs incurred during replacement of PP&E, except for certain demolition costs, should be charged to expense as incurred.
- During all stages, general and administrative costs and overhead costs, including costs of support functions, should be charged to expense as incurred.
- Costs of planned major maintenance activities are not a separate PP&E asset or component. Those costs should be charged to expense, except for acquisitions or replacements of components that are capitalizable under the in-service stage guidance of this SOP.
- A component is a tangible part or portion of PP&E that (1) can be separately identified as an asset and depreciated over its own expected useful life and (2) is expected to provide economic benefit for more than one year. If a component has an expected useful life that differs from the expected useful life of the PP&E asset to which it relates, the cost should be accounted for separately and depreciated or amortized over its expected useful life.

.92 Component accounting should begin at the time of acquisition or construction. Component accounting for a replacement should begin at the time of replacement. If an entity replaces a part or portion of a PP&E asset that has not been previously accounted for as a separate component, and the replacement meets the definition of a component, then the entity should capitalize the replacement, account for it as a separate component going forward, estimate the net book value of the replaced item, and charge that net book value to depreciation expense in the period of replacement.

- Amounts contractually recoverable by a lessor from a lessee, under the terms of an operating lease, for capital expenditures that benefit multiple lessees, should be accounted for as deferred revenue by the lessor and prepaid rent by the lessee. PP&E expenditures meeting the requirements of this SOP should be capitalized by the lessor.

.93 This SOP is proposed to be effective for financial statements for fiscal years beginning after December 15, 2001, with earlier application encouraged. Practitioners should be alert for the final issuance of the proposed SOP.

.94 Simultaneously with AcSEC's release of the proposed SOP, FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards, *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant and Equipment* (an amendment of Accounting Principles Board [APB] Opinions No. 20, *Accounting Changes*, and No. 28, *Interim Financial Reporting*, and FASB Statements No. 51, *Financial Reporting by Cable Television Companies*, and No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, and a rescission of FASB Statement No. 73, *Reporting a Change in Accounting for Railroad Track Structures*). That proposed Statement includes amendments to certain FASB pronouncements that would be made in conjunction with the issuance of the proposed SOP.

Auditing and Attestation Pronouncements and Guidance Update

.95 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. The AICPA *Audit Risk Alert—2001/02* [AAM section 8010] contains a summary explanation of all these issuances. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

.96 To obtain copies of AICPA standards and guides, contact Member Satisfaction at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 94	<i>The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit</i> (AICPA, Professional Standards, vol. 1, AU sec. 319)
SOP 01-3	<i>Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law</i>
SSAE No. 10	<i>Attestation Standards: Revision and Recodification</i> (AICPA, Professional Standards, vol. 1, AT secs. 101–701)
AICPA Audit Guide	<i>Auditing Derivative Instruments, Hedging Activities, and Investments in Securities</i> (product no. 012520kk)
AICPA Audit Guide	<i>Auditing Revenue in Certain Industries</i> (product no. 012510kk)
AICPA Audit Guide	<i>Audit Sampling</i> (product no. 012530kk)
AICPA Audit Guide	<i>Analytical Procedures</i> (product no. 012551kk)
Practice Alert 01-1	<i>Common Peer Review Recommendations</i>

Accounting Pronouncements and Guidance Update

.97 Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. The AICPA *Audit Risk Alert*—2001/02 [AAM section 8010] contains a summary explanation of all these issuances. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 141	<i>Business Combinations</i>
FASB Statement No. 142	<i>Goodwill and Other Intangible Assets</i>
FASB Statement No. 143	<i>Accounting for Asset Retirement Obligations</i>
FASB Technical Bulletin No. 01-1	<i>Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets</i>
FASB Statement No. 144	<i>Accounting for the Impairment or Disposal of Long-Lived Assets</i>
SOP 00-3	<i>Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts</i>
SOP 01-1	<i>Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools</i>
SOP 01-2	<i>Accounting and Reporting by Health and Welfare Benefit Plans</i>
AICPA Audit and Accounting Guide	<i>Audits of Investment Companies</i> (product no. 012365cv)
Questions and Answers	<i>FASB Statement No. 140</i>

On the Horizon

.98 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that are especially relevant to the CIRA industry. Remember that exposure drafts are nonauthoritative and cannot

be used as a basis for changing GAAP or GAAS. The AICPA *Audit Risk Alert*—2001/02 [AAM section 8010] summarizes some of the more significant exposure drafts outstanding.

.99 The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft.

<i>Standard Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
FASB	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process the submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

New Framework for the Audit Process

.100 The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB expects to issue a series of exposure drafts in late 2001 and 2002. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "expectation gap" standards were issued in 1988.

.101 Some of the more important changes to the standards that are expected to be proposed are:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Among other things, this will improve the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit.
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures.

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

.102 You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Resource Central

Educational courses, Web sites, publications, and other resources available to CPAs.

On the Bookshelf

.103 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities Audit Guide* (product no. 012520kk)
- *Auditing Revenue in Certain Industries Audit Guide* (product no. 012510kk)
- *Audit Sampling Audit Guide* (product no. 012530kk)
- *Analytical Procedures Audit Guide* (product no. 012551kk)
- *Auditing Estimates and Other Soft Accounting Information Practice Aid* (product no. 010010kk)
- *Accounting Trends & Techniques—2001* (product no. 009893kk)
- *Preparing and Reporting on Cash- and Tax-Basis Financial Statements Practice Aid* (product no. 006701kk)
- *Consideration of Internal Control in a Financial Statement Audit—1997* (product no. 012451kk)
- *Use of Real Estate Appraisal Information 1997* (product no. 013159kk)
- *Common Interest Realty Associations Checklist* (product no. 008764kk)
- *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (product no. 008883kk)

Audit and Accounting Manual

.104 The *Audit and Accounting Manual* (product no. 005131kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs, auditors' reports, checklists, engagement letters, management representation letters, and confirmation letters.

CD-ROM

.105 The AICPA is currently offering a CD-ROM product titled *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 that includes all Guides and the related Audit 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.

Educational Courses

.106 The AICPA has developed a number of continuing professional education courses that are valuable to CPAs working in the CIRA industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (2000–2001 edition) (product no. 737061 [text] 187078 [video]). Whether you are in industry or public practice, this course keeps you current and informed, and shows you how to apply the most recent standards.

- *Independence* (product no. 739035). This new interactive CD-ROM course will review the AICPA authoritative literature covering independence standards, including the newly issued SEC Practice Section (SECPS) independence requirements, SEC regulations on independence, and International Standards Board (ISB) standards.
- *Internal Control Implications in a Computer Environment* (product no. 730617). This practical course analyzes the effects of electronic technology on internal controls and provides a comprehensive examination of selected computer environments, from traditional mainframes to popular personal computer set-ups.

Online CPE

.107 The AICPA offers an online learning tool, AICPA InfoBytes. An annual fee (\$95 for members and \$295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today as our guest at infobytes.aicpaservices.org.

CPE CD-ROM

.108 The Practitioner's Update (product no. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

.109 To order AICPA products, receive information about AICPA activities, and find help on your membership questions call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.110 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.111 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.

Web Sites

AICPA Online

.112 AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, AICPA Online offers information about AICPA products and services, career resources, and online publications.

CPA2Biz

.113 You can order AICPA products and obtain guidance about various accounting and auditing matters online at cpa2biz.com.

Other Helpful Web Sites

.114 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the Appendix [paragraph .117].

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This Audit Risk Alert replaces *Common Interest Realty Associations Industry Developments—2000/01*.

.116 The Audit Risk Alert *Common Interest Realty Associations 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 those with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to lwest@aicpa.org, or write to:

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Appendix

The Internet—An Auditor's Research Tool

Some Web sites that may provide valuable information to auditors are listed in the following tables.

Association-Related Information:

<i>Organization</i>	<i>General Contact Information</i>	<i>Internet Address</i>
Community Associations Institute	1630 Duke Street Alexandria, VA 22314 (703) 548-8600	www.caionline.org
National Association of Housing Cooperatives	1401 New York Avenue #1100 Washington, DC 20005 (202) 383-5475	www.coophousing.org
American Resort Development Association	1220 L Street, Ste 500 Washington, DC 20005 (202) 371-6700	www.arda.org

General Web Sites of Interest:

<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	www.aicpa.org
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
The Electronic Accountant	World Wide Web magazine that features up-to-the-minute news for accountants	www.electronicaccountant.com
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com
Guide to WWW for Research and Auditing	Basic instructions on how to use the Web as an auditing research tool	www.tetranet.net/users/gaostl/guide.htm
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com
Double Entries	A weekly newsletter on accounting and auditing around the world	www.csu.edu.au/lists
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
Federal Reserve Bank of New York	Key interest rates	www.ny.frb.org/pihome/statistics/dlyrates
Cybersolve	Online financial calculators such as ratio and breakeven analysis	www.cybersolve.com/tools1.html

<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	www.fedworld.com
Hoovers Online	Online information on various companies and industries	www.hoovers.com
Vision Project	Information on the profession's vision project	www.cpavision.org/horizon
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	www.kentis.com/ib.html
Federal Communication Commission	FCC-sponsored site providing access to rulings and other FCC information	www.fcc.gov
Federal National Mortgage Association	FannieMae-sponsored site providing access to products and other FannieMae information	www.fanniemae.com
Federal Home Loan Mortgage Corporation	FreddieMac-sponsored site providing access to products, forms, business tools, and other FreddieMac information	www.freddiemac.com
Department of Veterans Affairs	VA-sponsored site providing access to online applications, special programs, and other VA information	www.va.gov
U.S. Dept. of Housing and Urban Development	HUD-sponsored site providing access to notices and other HUD information	www.hud.gov

[The next page is 8247.]

AAM Section 8090

Construction Contractors Industry Developments—2002/03

How This Alert Can Help You

.01 This Audit Risk Alert can help you plan and perform your construction industry audits. The knowledge that this Alert delivers can assist you in achieving a more robust understanding of the business environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the construction industry, and if you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert can assist you in making considerable strides in gaining that industry knowledge and understanding it.

.03 This Alert describes trends and issues facing most contractors in many of the construction markets in the country. National trends and industry-wide benchmarks can help you identify unusual financial statement relationships at the planning or final review stages of an audit. Once they are identified, you can direct your audit attention to those areas. However, broad national trends have their limitations. Keep in mind that your clients will be affected much more by local economic, political, and industry conditions that exist in the specific markets that your clients serve.

.04 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

The U.S. Business Environment

.05 As of the third quarter of 2002, anxious economists are downgrading their forecasts, and some crucial sectors of the economy are pushing the likelihood of a rebound into next year because of the abrupt slowdown in the economic recovery.

.06 For now, the overall economy is expanding, but sluggishly. Jobs are growing, but barely. And with a depressed stock market and reactions to further fears of terrorist strikes weighing on the national psyche, there is none of the exuberance that marked the recovery in the late 1990s.

.07 Analysts argue over whether the summer slump was just a pause in the rebound—perhaps as companies obsess about making sure their financial reports are accurate—or something more ominous. Even optimists say the once-slim chances of a double-dip recession, meaning a recession followed by a short period of growth only to be followed by another recession, are now up to 20 percent or more.

.08 The economy appears to be in a struggle between declining business confidence and strong consumer spending. Eventually, consumer demand should overcome business wariness unless cautious businesses cut so many jobs that consumers finally give up. The same dynamic was at work during the fall of 2001. After September 11th of that year, the business sector froze, but the consumer sector did not, and eventually consumer demand jump-started the economy.

.09 The underlying economic fundamentals remain relatively sound and point toward a moderate economic growth scenario. However, stock market weakness coupled with recent data releases has prompted downward forecast revisions.

Factors Affecting the Current Environment

.10 The confluence of many factors blend to create the uncertainty mix we are experiencing in these economic times. Among those factors are stock market woes, current monetary policy, spending policies of different sectors, and manufacturing activity, as discussed in the following sections.

Stock Market Woes

.11 Accounting scandals and corporate bankruptcies have generated tremendous investor uncertainty resulting in a dramatic decline in stock prices. While this is disconcerting, Wall Street scandals are not expected to play a *significant* adverse role on consumer spending or overall economic growth. Furthermore, any negative economic effects generated by stock price declines are expected by economists to be constrained to third quarter activity.

.12 Potentially, the decline in stock market prices can affect real economic activity by reducing consumer wealth and by adversely affecting consumer buying attitudes. Both conditions could reduce consumer spending activity.

.13 Stock prices declined 25 percent from July to September 2002—resulting in a \$2.6 trillion decline in wealth holdings. Most economists believe the decline in wealth will have a relatively small adverse impact on consumer spending. The wealth decline is primarily a temporary paper setback for investors. The underlying economic fundamentals are relatively sound, and the profit picture facing corporate America is showing mixed signs of improvement. This suggests that once investors regain confidence in corporate financial reporting, the market will rebound strongly.

.14 Furthermore, the current environment of low interest rates and stock uncertainty has prompted additional support to real estate activity, contributing to real estate appreciation.

Current Monetary Policy

.15 Some economists expected a monetary policy reversal to materialize during the fourth quarter of 2002. Most now assume that the Federal Reserve will not engage in a monetary policy tightening until the first quarter of 2003—at the earliest. The new assumption is made in the context of the recent declines in stock prices and the continued fragility of the economic recovery.

Consumer Spending

.16 The economic improvement during 2002 has been carried on the shoulders of the consumer, who accounts for roughly two-thirds of overall economic activity. However, there are serious concerns within the analytical community whether strong consumer spending can last long enough for the other sectors of the U.S. economy to become a net contributor.

.17 Recent data releases suggest that the consumer sector shows no signs of faltering. Aside from a moderation in third quarter consumer spending growth due to stock market woes, economists expect the current strength in consumer spending to endure—enabling other sectors of the economy to turn positive.

.18 Consumer buying attitudes aside, moderate income growth, low inflation, low interest rates, lower energy prices, and retailers' discounting activity should underpin relatively strong consumer affordability conditions.

Investment Spending

.19 Clearly, the dividing factor between a weak economic recovery and stronger growth performance will be the extent to which other sectors of the economy become net contributors to gross domestic product (GDP) growth. The timing and strength of a recovery in business capital spending will play a large role in determining the strength of economic activity during the next year.

.20 Corporate investment spending has been an area of sustained weakness for the U.S. economy for the past year. Business expenditures for new plant and equipment will not begin to recover until corporate profitability shows sustained growth. Throughout 2001, corporate profits recorded declines. To defend its bottom line, the corporate community cut back in investment spending.

.21 Sustained improvement in corporate profits should draw corporate America out of its capital-spending hiatus. The combination of sustained strength in consumer spending, improved conditions in the manufacturing sector, and renewed strength in corporate profits (as well as improvement in the stock market), is expected to lead to a small positive increase in business expenditures for new plant and equipment. Stronger gains in this area are expected throughout 2003.

Government Spending

.22 During the past few years, two key factors have influenced government spending—robust economic conditions and, therefore, robust government revenue sources, and a commitment by policymakers to insure a federal surplus. Things have changed. The slowdown in economic activity has slowed growth in government revenue. Expenses associated with the war on terrorism at home and abroad will add to government spending. Furthermore, Congress is less likely to trumpet the cause of a balanced budget in the context of increased government measures to improve domestic security.

.23 As a result, government spending through 2003 is expected to accelerate, contributing more to GDP growth. As a consequence, federal spending deficits are expected to persist at least through the first half of 2003. This trend has already been the experience during the first quarter of 2002, for which the government recorded a deficit of \$64 billion.

Manufacturing Activity

.24 Recovery in the manufacturing sector is critical in sustaining economic momentum. Despite an improved outlook, the sector remains weak. Although there are conflicting reports surrounding the manufacturing sector, economists believe that the sector is improving at a modest rate. The two key factors in this assessment are continued strength in consumer spending and a sustained lean inventory position. With these two factors in place, monthly fluctuations in durable goods orders play a less important role in the assessment of the ongoing recovery in manufacturing.

Sarbanes-Oxley Act

.25 On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the Act). The Act includes far-reaching changes in federal securities regulation that could represent the most significant overhaul since the enactment of the Securities Exchange Act of 1934. The Act creates the Public Company Accounting Oversight Board (PCAOB) to oversee the audits of public companies that are subject to the securities laws of the Securities and Exchange Commission (SEC). In addition, the Act prescribes a new set of auditor independence rules, new disclosure requirements applicable to public companies and insiders, and harsh civil and criminal penalties for persons responsible for accounting or reporting violations. The Act also imposes new restrictions on loans and stock transactions involving corporate insiders.

.26 A more complete summary of the Act is available on the AICPA Web site at www.aicpa.org/info/sarbanes_oxley_summary.htm. We discuss some of the provisions of the Act that may be of particular interest to publicly traded companies below.

.27 For public companies, the Act's most noticeable effects relate to corporate governance, an area of regulation traditionally left to state corporation laws. The Act will force many companies to adopt significant changes to their internal controls and the roles played by their audit committees and senior management in the financial reporting process. Most significantly, the Act imposes new responsibilities on CEOs and CFOs and exposes them to much greater potential liability for the information presented in their companies' financial statements, among other things.

.28 The Act includes the following changes to the law that took effect immediately or within 30 days of becoming law:

- *Certification of periodic reports; criminal sanctions for false certification.* The criminal provisions of the Act contain a new certification requirement that received little or no attention from commentators prior to the Act's enactment. This requirement, which carries criminal penalties, applies to any periodic report containing financial information (presumably including a Form 8-K). The certification requirement states that such a report must be accompanied by a written statement signed by the CEO and the CFO certifying that the report "fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934" and that the information "fairly presents, in all material respects, the financial condition and results of operation of the issuer." An officer who knowingly makes a false certification as to these matters may be subject to a fine of up to \$5 million and imprisonment of up to 20 years. This provision creates a separate and independent certification requirement that is not subject to SEC rulemaking and is effective immediately. The certification requirement goes beyond the certification discussed below and is required for periodic reports beginning with an issuer's next filing. All issuers should carefully consider these provisions with their legal counsel well in advance of making their next filing.
- *Certification accompanying 10-Ks and 10-Qs.* The Act directed the SEC to issue rules within 30 days of becoming law to require the CEO and the CFO of a reporting company to personally certify the company's reports on Form 10-K and Form 10-Q. The certification must state that the officer has read the report and must confirm, based on the officer's knowledge, the absence of material misstatements or omissions and the fair presentation of the accompanying financial information. The certification also must provide statements regarding the company's financial controls and confirm that the officers have made certain specified disclosures to the company's auditors and audit committee.
- *Audit committees.* Under the Act, audit committees are subject to heightened independence standards (including a prohibition of any non-independent members), and companies are required to grant their audit committees specific levels of control over the company's relationship with its auditors. These control levers would include, for example, exclusive hiring, firing, and spending authority. Audit committees are required to establish rules for (1) the treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters, and (2) confidential submission by employees of concerns regarding questionable accounting or auditing matters.
- *Insider transactions.* Loans to directors and executive officers are prohibited in almost all circumstances, as are the modification or forgiveness of currently outstanding loans. Insider stock transactions must be reported within two business days of the date of the transaction.
- *Forfeiture of CEO and CFO compensation.* Financial restatements arising from misconduct could result in forfeiture by the issuer's CEO and CFO of bonuses paid to them and profits from their stock sales during the year following the original reporting of the results. There is no provision requiring that the CEO or CFO have any culpability in the misconduct. However, the Act permits the SEC to exempt any person from the application of this provision, as it deems "necessary and appropriate."

- *Statute of limitations in securities fraud litigation.* The statute of limitations for private securities fraud litigation has been significantly lengthened to the earlier of two years from the date of discovery or five years from the date of the violation.

.29 Additional changes that will take effect in the following months, as the SEC issues rules implementing the changes and as auditors become registered with the PCAOB, include, among other things:

- *Auditor independence.* Accounting firms are prohibited from providing most nonaudit services for public companies they are auditing. Tax services and some other nonaudit services may be provided if preapproved by the audit committee. Most of the other nonaudit services that have been provided by accounting firms in the past, however, are absolutely prohibited, including design and implementation of financial information technology (IT) systems, appraisal or valuation services, and legal services and expert services unrelated to the audit, among others.
- *Additional disclosures in periodic reports.* Periodic reports must include disclosures regarding the issuer's internal controls; nonaudit services provided by the issuer's auditor; and material off-balance-sheet transactions, arrangements, or obligations. The reports must disclose whether the issuer has adopted a code of ethics for senior financial officers and, if not, why not. Companies must disclose any change to the code or any waiver of its provisions in a Form 8-K. The reports must disclose whether the issuer's audit committee includes at least one member who constitutes a "financial expert" according to criteria specified in the Act (generally a person with experience as a CFO or controller or similar accounting experience).
- *Adjustments identified by auditors.* The Act requires that any periodic report that contains generally accepted accounting principles (GAAP) financial statements "reflect" all material correcting adjustments that have been identified by the issuer's auditors in accordance with GAAP or the rules and regulations of the SEC.
- *Discussions between auditors and audit committees.* Auditors are specifically required to discuss certain matters with the audit committee, including (1) critical accounting policies and (2) alternative accounting treatment of financial information that has been discussed with management, the ramifications of the alternative treatment, and the treatment preferred by the auditors.
- *Auditor conflict of interest rules.* An accounting firm may not perform audit services for an issuer whose CEO, CFO, controller, or chief accounting officer participated in the audit of the issuer on behalf of the accounting firm during the previous year.
- *Pro forma financial information.* Pro forma financial information must be accompanied by a reconciliation with financial information that conforms to GAAP.
- *Disclosure of misconduct by attorneys.* The Act directs the SEC to adopt rules of professional responsibility requiring attorneys to report a material violation of securities laws or breach of fiduciary duty to the issuer's chief legal officer or CEO, and thereafter, if there is not an adequate response, to the audit committee or the board of directors.

.30 The Act applies only to publicly traded companies. It will have limited direct impact on construction firms, because most of the firms in the industry are privately held. With all the current attention on corporate governance issues, however, some private firms may choose to re-examine their own policies or emulate the Act's provisions in that area.

.31 Some public construction firms say they already comply with at least some of the new legislation's elements. But other firms are looking at steps to improve governance. One idea for taking improvement measures is introducing "continuing education" for audit committee members on percentage-of-completion accounting for construction contracts, for example.

Construction Industry Overview

.32 The construction industry consists of individuals and companies engaged in diverse types of activities that are defined as construction in the *Standard Industrial Classification Manual*. In the United States, the construction industry represents billions of dollars of economic activity, consists of several hundred thousand business entities that are widely dispersed throughout the country, employs a large labor force, and contributes a relatively constant annual percentage (approximately 5 percent) to the gross national product (GNP).

Are All Contractors Alike?

.33 No, not all contractors are alike. Not only do contractors offer different kinds of services; they also have different capabilities. Consequently, the economic and audit risks associated with contractors vary. For example, the business risks and issues facing residential home builders may be very different from those risks encountered by contractors and subcontractors who work on commercial office buildings. You have to consider the contractor within the context of the market segment that he or she serves to better understand the industry and what you need to know about that industry (segment) as an auditor. This Alert describes conditions for the following kinds of contractors.

- *Residential building.* These contractors are engaged in the construction of new single-family and multifamily residential buildings. A number of contractors are involved strictly in the remodeling and maintenance of residential buildings.
- *Nonresidential building.* These contractors specialize in the construction of commercial buildings, such as offices and industrial, retail, and lodging facilities.
- *Heavy construction.* These contractors are engaged in projects such as highways, bridges, dams, railroads, and airports.
- *Specialty trade.* These contractors specialize in work such as painting, electrical, roofing, plumbing, and other specialty trades. Contractors in the specialty trades frequently work as subcontractors on a wide variety of projects.

.34 The organizational structure, resources, and capabilities of contractors vary with the type of activity, and each kind of contractor can pose different accounting and auditing problems. However, certain characteristics are common to all entities in the construction industry. The most basic common characteristic for construction entities is that work is performed under contractual arrangements with a customer. Regardless of the type of construction activity or the type of contractor, a contractor typically enters into an agreement with a customer to build or make improvements on a tangible property to the customer's specifications. Other characteristics common to all contractors and significant to auditors include the following:

- A contractor normally obtains the contracts that generate revenue or sales by bidding or negotiating for specific projects.
- A contractor bids for or negotiates the initial contract price based on an estimate of the cost to complete the project and the desired profit margin, although the initial price may be changed or renegotiated.
- A contractor may be exposed to significant risks in the performance of a contract, particularly when the contract is a fixed-price contract.
- Customers frequently require a contractor to post a performance and a payment bond as protection against the contractor's failure to meet performance requirements.
- The costs and revenues of a contractor are typically accumulated and accounted for by individual contracts or contract commitments extending beyond one accounting period, which complicates the related management, accounting, and auditing processes.

Funding Sources for Construction

.35 To better understand the dynamics of the construction industry, it also helps to consider its source of funding. *Publicly* funded construction is financed by federal, state, and local governments and is driven by the political and legislative processes. For example, the passage of bond measures to fund school construction has resulted in increased construction activity in many areas during the past year. *Privately* funded construction is financed by private owners, such as real estate development companies, home builders, and various business entities. The need for privately funded construction is influenced by a wide variety of economic forces, including the availability of capital, the status of the local and world economy, the level of interest rates, and demographics.

Industry and Economic Developments

General Industry Trends and Conditions

.36 During the first eight months of 2002, the steady volume for total construction compared to 2001 was the result of a varied performance by major sector. Residential building maintained a 9 percent lead over the previous year, nonbuilding construction was up 1 percent, and nonresidential building was down 9 percent. By geography, total construction performed as follows during the January-August period: the Northeast, up 7 percent; the South Atlantic, up 6 percent; the Midwest, up 1 percent; the West, unchanged; and the South Central, down 9 percent. Overall, total construction was just about the same as that indicated during the same period in 2001.

.37 David Wyss, chief economist for Standard & Poor's, predicts that GDP will grow at an annual rate of 3-1/2 percent during the second half of 2002 and then inch up to a 4 percent annual rate during the first half of 2003. However, any mild economic recovery like the one Wyss predicts does not seem to have enough strength to pull construction up with it. In 2002, construction increasingly became two distinct markets. Housing and public construction continued their long expansion, but many of the private nonresidential building markets are close to, if not in, recession. Through July, construction saw year-to-date declines of 44 percent for office buildings, 29 percent for hotels, 25 percent for commercial buildings, and 17 percent for the already depressed industrial market, according to the U.S. Department of Commerce. During the same period, public markets experienced year-to-date increases of 24 percent for hospitals and 16 percent for schools, while highway, water, and sewer work remained strong. In addition, low interest rates continued to keep the housing market growing.

.38 The construction industry still faces the following uncertainties: Will the economy recover fast enough to snap the private nonresidential building market out of its funk? Or will growing federal and state budget deficits eventually pull the plug on the public sector? Finally, will a poor job market and falling consumer confidence overcome the lure of low interest rates and end the housing market's remarkable run?

.39 Construction economist Bill Toal remains cautiously optimistic for the remainder of 2002 and beyond. He is forecasting a 1.6 percent drop in total construction for 2002, with an expected increase of 1.4 percent in 2003. Toal indicated that, while some sectors remain weak, the economy is now showing signs of improvement. Some of the more apparent signs of recovery include an increase in industrial production and record low inflation and interest rates. Due to these low interest rates, consumer spending continues to be strong, and auto sales and housing starts are still robust. As a result, residential construction remains stronger than expected, although a small dip is expected before the end of the year.

.40 While industrial construction had slipped in the beginning of 2002, it has recently shown signs of improvement. However, the corporate office market is still declining, as there is the impression that things

may be worse than previously thought in the corporate sector due to recent financial scandals. Commercial and industrial real estate were previously overbuilt, and that overbuilding contributed to the high office vacancy rate, which has increased from 7 percent last year to over 15 percent in 2002. While the job loss rate has declined, layoffs and downsizing continue to contribute to the imbalance between available office space and corporate need for that space.

.41 Earlier forecast numbers for residential construction have now been revised upward. Housing starts were predicted to drop below 1.5 million for the year from 1.6 million in 2001, but are now expected to finalize at 1.55 million starts for 2002. Industrial and commercial construction have dropped off significantly in 2002, and economists suggest this is a red flag for this segment of the market, with a forecast drop of 10.8 percent by year's end. However, the industrial and commercial sector is forecast to begin recovering with a 5 percent increase anticipated in 2003.

.42 One of the most widely used measures of construction activity is *construction put in place*, which is tracked monthly by the Bureau of Statistics at the U.S. Department of Commerce. The *value of construction put in place* is a measure of the value of construction installed or erected at the site during a given period. For an individual project, this includes:

- New buildings and structures
- Additions, alterations, major replacements, and so on, to existing buildings and structures
- Installed mechanical and electrical equipment
- Installed industrial equipment, such as boilers and blast furnaces
- Site preparation and outside construction, such as streets, sidewalks, parking lots, utility connections, and so on
- Cost of labor and materials (including owner supplied)
- Cost of construction equipment rental
- Profit and overhead costs
- Cost of architectural and engineering (A&E) work
- Any miscellaneous costs of the project that are on the owner's books

.43 The total value-in-place for a given period is the sum of the value of work done on all projects underway during this period, regardless of when work on each individual project was started or when payment was made to the contractors. For some categories estimates are derived by distributing the total construction cost of the project by means of historic construction progress patterns.

.44 Exhibit 1, "New Construction Put in Place," presents details of construction put in place for various market segments. (Note that the amounts are in billions of dollars and represent seasonally adjusted annual rates.) To add some perspective, in January 1992, at the start of the current construction boom, the total new construction put in place was \$452 billion, as compared with the estimated 2001 amount of \$830 billion—a gain of more than 83 percent during the period.

Exhibit 1

New Construction Put in Place
(Billions of Dollars—Seasonally Adjusted Annual Rate, in Current Dollars)

	<i>August 2002</i>	<i>August 2001</i>
Private construction	\$627.1	\$644.3
Public construction	202.7	201.2
Total construction	829.8	845.5
Residential building	407.5	387.3
Nonresidential building		
Office	36.3	48.6
Industrial	14.9	30.8
Retail and other commercial	51.8	58.5
Hotels and motels	9.4	14.2
Other nonresidential	46.8	44.6
Total nonresidential	159.2	196.7
Telecommunications	0.0	0.0
All other private construction	60.4	60.3
Total private construction	627.1	644.3
Highways and streets	51.3	55.8
Infrastructure	24.9	19.8
Educational buildings	63.1	54.3
Other public buildings	30.8	33.9
Other public construction	32.6	37.4
Total public construction	202.7	201.2

Help Desk—You can access current statistics of construction put in place and other construction industry information at www.census.gov.

Private Construction

Residential Building

.45 The residential building segment of the construction industry includes new single- and multi-family housing as well as residential repairs and improvements. Conditions with the most impact on the demand for residential construction include the following.

- *Housing affordability.* Housing affordability is the extent to which potential buyers have the means to purchase a home. Affordability can be measured in several ways by considering average home prices and income levels. For example, some analysts create an “affordability index” by comparing median home prices to household income levels. As income levels get closer to housing prices, the average home becomes affordable to more local residents.

- *Interest rates.* Most homes are financed, therefore interest rates have a tremendous effect on the affordability of housing. As interest rates rise, the cost of home financing increases; as they fall, the cost of financing decreases. However, interest rate changes do not have an immediate impact on home buying markets—usually rates have to be in effect for several quarters to reverse home buying trends.
- *Demographics.* Shifts in demographics can have a significant impact on housing demand. For example, the aging of the U.S. population has increased demand for low-maintenance and multifamily housing. A large number of baby boomers are now entering their peak earning years, which is expected to affect the affordability and demand for single-family homes.
- *Market velocity.* According to industry sources, more than half of all home improvements occur within 18 months after a new owner moves in, or within 12 months before the home is sold. Thus, during times when new and used home markets are active, residential remodeling and improvement activity also increases.

.46 As one of the main drivers of construction's recent 10-year expansion, homebuilding continues to prop up the industry's growth as other sectors go into decline. With the Federal Reserve Board setting its benchmark for interest rates at its lowest level in 40 years, and with strong demographics, homebuilding has shrugged off stock market woes and growing unemployment to keep growing.

.47 Housing clearly was outperforming its commercial building counterpart even before the commercial market began to weaken last year. At the peak of the expansion between 1997 and 2000, the value of single-family housing increased 35 percent, compared to a 20 percent increase in the value of private nonresidential buildings, according to the U.S. Department of Commerce.

Nonresidential Building

.48 As previously stated, industrial and commercial construction dropped off significantly in 2002, with a forecast drop of 10.8 percent by the end of the year. In addition to the general state of the economy, the following trends in the commercial real estate industry are particularly relevant for contractors.

- *Demographic shifts.* For years now, we have watched the baby boomers age. The first part of this generation is now beginning to retire and enter the "active leisure" years. Meanwhile, the number of people in their primary working years (ages 25 to 44) continues to decline. Real estate analysts predict that these trends will have the following impact on the demand for real estate.
 - The aging baby boomers will increase the demand for properties that are tailored to meet their needs. These properties are not limited to elder care facilities or golf course communities. Because they are a group interested in active leisure pursuits, the demand for a wide variety of projects such as resorts, entertainment, and recreational venues is expected to grow. Additionally, the aging baby boomers will begin to have an effect on the retail industry and the related demand for retail space.
 - Most economists are predicting that the shrinking size of the work force will result in most businesses facing the kind of labor shortages that have plagued the construction industry for the past few years. Companies will have to address employee satisfaction and retention issues, which will affect the demand for commercial real estate. For example, the increased practice of telecommuting may ultimately reduce the demand for office space.
- *Electronic commerce (e-commerce).* For the past few years, as the popularity of online shopping has grown, some business observers have predicted the slow demise of the traditional "brick and mortar" retail outlet. In fact, that does not appear to be happening. Although online retailing, also known as electronic retailing or e-tailing, has grown significantly, the evidence now suggests that shopping over the Internet may actually increase traffic at the mall. Most analysts assumed that online shopping was done at the expense of traditional retailing, but it appears that the retail market "pie" is actually getting larger.

One area in which e-commerce has affected demand is in the industrial sector of the real estate market. Previously, many online retailers were set up to be “virtual companies” that essentially processed sales orders. Now, many of these companies are holding inventory and taking control of the distribution process. Large online retailers such as Amazon.com need large amounts of warehouse space to store their ever-increasing inventories, and this need is beginning to be felt in the industrial construction market.

Although nonresidential construction is expected to rebound, with economists predicting a 5 percent increase in 2003, some market segments will fare better than others. The following discussion describes the trends in each of these nonresidential construction segments.

Office Market

.49 The office market has fallen farther and faster than anyone thought possible a year ago. The vacancy rate, which reached a cyclical low point of 8.5 percent in the third quarter of 2000, currently stands at 15 percent, well above the 10 percent rule of thumb for a balanced market. By 2003, with the construction pipeline largely depleted and the potential for a rebound in demand, the market should be poised to tighten again, moving from the saturation phase to the recovery phase of the real estate cycle. Speculative construction (construction of unleased space), which is rapidly disappearing, may be warranted again as early as 2005.

Industrial Market

.50 The industrial market is struggling under the weight of the recession, but there are pockets of activity amidst the gathering quiet. Hardest hit are the big box warehouse-distribution buildings of 100,000 square feet and up. These were the provinces of national, publicly traded retailers, which have been quick to cut back operations.

.51 Despite weakness in certain areas and product types, the industrial market has not followed the pattern of decline in the office market sector because the construction cycle is not as steep. An industrial development project can be completed in six to nine months, while an office project requires more than twice that long. At year end 2001, the industrial market had less space under construction than the office market, although the total industrial inventory in the United States is three times as large as the office inventory.

.52 One corner of the market that remains in high demand is for the general industrial buildings that are less than 100,000 square feet. As a primary user of this type of facility, smaller, privately held companies have been slow to downsize in the current cycle, and low interest rates are a boon to owner-users who want to purchase their buildings.

Retail and Other Commercial Markets

.53 The year 2002 has been a challenging one for the nation’s retailers. While there were a few strong performers (such as Wal-Mart), most of the nation’s merchants experienced weakened sales results and reduced profit margins as they struggled in a weakened economy. With weakened or declining sales, many department store chains have reduced expansion plans and closed or sold underperforming units.

.54 Moving forward into 2003, rising unemployment coupled with a stagnant global economy and fear of continued episodes of terrorism may restrict sales gains. Still, the aggressive steps taken by the Federal Reserve should help stabilize prices and lift demand over the year.

Hospitality Market

.55 Occupancies in the hospitality sector will suffer from a continued slowdown in corporate travel in 2002. The demand for lodging is being rocked by a variety of economic and security concerns, including the

failure of the economy to strengthen to the extent most economists had forecast, the negative wealth effect from the sharp decline in stock values in July, the erosion in consumer confidence, increasing frustration with the inconvenience of air travel, and heightened fears of U.S. action against Iraq.

.56 The economy and the specific effects of the recent events will restrain lodging demand growth and encourage continued discounting through the end of 2002, according to PricewaterhouseCoopers. They are forecasting revenue per available room (RevPAR) to decline 2.3 percent in 2002. Without a catalyst for strong rebound in business travel in the short term, RevPAR will increase by only 3.5 percent in 2003. A more robust outlook is delayed to 2004, when RevPAR is expected to improve by 5.6 percent.

Help Desk—The demand for construction can vary significantly among different geographic regions. One of the most comprehensive analyses of commercial real estate demands and construction activity is published by the Society of Industrial and Office Realtors (SIOR). Annually, SIOR publishes *Comparative Statistics of Industrial and Office Real Estate Markets*, which provides detailed real estate and construction statistics on all of the country's larger cities. You can purchase and download this publication directly from the publications section of the SIOR Web site at www.sior.com.

Public Construction

.57 Compared to 2001, public construction put in place in 2002 increased by less than 1 percent, from \$201.2 billion to \$202.7 billion. School construction will remain strong through the final two quarters of the year, as will public works. In particular, public works has and will continue to benefit from the U.S. Transportation Equity Act for the 21st Century (TEA21), which provides federal funding for transportation construction. This high-level funding, which has been in place since the Act was passed in 1998, will continue to trickle down through public works construction and help maintain that market segment's strength.

Surety Industry Trends

.58 The surety industry is critical to the well-being of the construction industry. Nearly half of all work performed by contractors is bonded, and so any change in the surety market will have a significant effect on the construction industry.

.59 Early in 2002, news stories questioning the strength and viability of the surety industry began to surface. Even before the economic crisis and other calamitous events of the past 12 months, industry analysts were reporting on the tightened surety bond market and predicting possible effects on the construction industry.

.60 In general, the causes of the changes in the surety industry include:

- Reinsurers tightening the terms and conditions of their agreements with sureties and raising rates because of generalized losses in the primary insurance and surety industries.
- Consolidation of the reinsurance and primary surety market, as reputable surety companies are acquired, close shop, or discontinue writing surety.
- Mounting claims and losses.
- Losses cutting into healthy profits.
- Contractors in default.
- Relaxed underwriting standards by sureties.

Certainly, the surety industry is in a state of flux that has not been experienced in many years. Many surety companies have been heavily involved in commercial surety (including guaranteeing certain financial commitments). Many of the larger surety companies are currently involved in litigation with certain financial institutions. Should these companies lose the litigation, it is possible that more surety companies may disappear.

.61 In addition, a large judgment was handed down against two of the nation's larger surety companies. Although most of the loss is reinsured, this loss will strap those reinsurers and may make other reinsurers reluctant to enter the primary surety market.

.62 The changes in the surety industry will affect each contractor differently. Some may not even notice much of a change. Those most affected will be the large contractors (premiums of \$500,000 and greater) and small contractors (premiums of \$25,000 or less). Because of fewer sureties available, large contractors may need co-sureties to handle needs on very large projects. Small contractors, on the other hand, may see considerably higher rates, requests for more detailed information, and a longer timeline to obtain surety credit. The least affected group will be the mid-sized contractors (premiums between \$25,000 and \$500,000), although sureties may require more information and expect it in a timely manner.

Construction Cost Trends

.63 The construction industry's new split personality is reflected in the cost trends reported in the *Engineering News Record's* "Third Quarterly Cost Report." Of the 29 construction material and equipment price indexes tracked by the Bureau of Labor Statistics (BLS), 11 show increases of between 1 percent and 5 percent over a year ago. Ten indexes show declines between 1 percent and 5 percent, while 6 show relatively stable price levels. Outside this group, prices are up 14 percent for gypsum wallboard and down 7 percent for aluminum sheet.

Materials

.64 The construction industry has typically been resistant to price hikes caused by temporary anomalies in supply and demand. Also, in the past, the inflation of construction material costs was widespread and developed rather slowly, giving contractors plenty of time to adjust. However, recent evidence suggests that these two characteristics of the cost structures of contractors are beginning to change.

.65 Prices are falling for materials trapped on the depressed side of the industry. For example, prices for fabricated structural steel used for buildings have fallen 2.4 percent below last year's level, according to the BLS producer price index for July. Materials with a high end-use in public works or housing are showing some price strength. However, of these, only gypsum wallboard and paving asphalt report price gains in the double digits. Paving asphalt prices are being driven by rising prices for crude oil, while wallboard prices are rebounding from last year's depressed levels.

.66 Variations in the price and availability of materials are not uniform across all kinds of building projects. Cost trends for building materials include the following:

- *Housing materials.* As described earlier in this Alert, the residential housing market has been robust. The resulting increase in demand for housing materials has led to an increase in the cost of key housing materials, such as lumber, insulation, bricks, and gypsum wallboard.
- *Concrete.* Throughout 2002, concrete prices have been on the increase. The string of price hikes has raised prices 9 percent above last year's level.
- *Petroleum-based materials.* Petroleum-based materials include paving asphalt, polyvinyl chloride (PVC) pipe, and some roofing materials. War jitters are adding an average \$4 premium on the price of a barrel of oil, according to the forecasting firm DRI-WEFA of Lexington, Massachusetts. Since the beginning of the year, the price of the benchmark West Texas Intermediate crude oil has steadily increased, and by August 2002 it was 47 percent above the December 2001 level.
- *Steel and aluminum.* By the third quarter of 2002, the full effect on prices of new U.S. tariffs on imported steel became clear. On March 5 President Bush placed a 30 percent tariff on most flat products, such as plate and sheet. Most of the so-called long products, which include construction

materials such as structural steel and reinforcing bar, were excluded from the tariffs. Prices for flat products increased 41 percent from the time the tariffs were put in place August 2002, according to the composite flat products price compiled by the forecasting firm DRI-WEFA. During the same period, the firm's composite price for long products rose just 2.5 percent.

Labor

.67 Labor costs continued to be the main inflation driver during the third quarter. However, both union and nonunion sectors seem to have taken into account weaker market conditions and growing unemployment in 2002 wage negotiations. In August 2002, the unemployment rate for both blue and white collar construction workers rose to 9.5 percent according to the BLS. Up from a low of 6.4 percent in 2000, it is now at its highest level since 1994.

.68 Open-shop contractors say that because of weaker market conditions, they only expect to increase wages for their workers by 4.2 percent, according to a survey conducted by Personnel Administration Services (PAS), Saline, Michigan. This would be down from a 4.8 percent wage increase that the same group of contractors awarded in 2001 and a 5.3 percent wage increase reported by PAS in 2000.

.69 The union sector also reeled in wage hikes this year, according to a survey of 165 settlements by the Construction Labor Research Council (CLRC) of Washington, D.C. Wage and benefit settlements reported to CLRC so far in 2002 have resulted in an average first-year increase of \$1.40, or a 4.2 percent annual wage hike. In 2001, union wages showed a 4.6 percent annual increase for the same period.

.70 Labor costs also are getting a kick from higher workers' compensation rates. This year, the average premium per \$100 of payroll increased 9 percent for structural ironworkers, 7 percent for bricklayers, and 2 percent for carpenters, according to an annual survey by the New York City-based insurance broker Marsh USA Inc.

.71 These rate increases just may be the first tremor in a major upheaval in workers' compensation rates expected to hit the market by next year. Industry sources expect to see double-digit rate increases in 2003.

Help Desk—The *Engineering News Record* publishes detailed quarterly cost studies. These cost studies track average prices for a wide variety of materials and labor classifications in major cities across the country. You can access summaries of the studies at the magazine's Web site at www.enr.com.

.72 Construction cost trends, like those mentioned in this section of the Alert, must be considered in the estimates developed by construction contractors. See "Estimating Costs to Complete" in the following section of this Alert for a discussion of audit considerations related to these cost estimates.

Current Audit Issues and Developments

Assessing Audit Risks in the Current Environment

.73 The proper planning and execution of an audit has always required you to have a thorough understanding of the construction industry and the nature of your client's business. For most audit firms, this in-depth understanding means that the most experienced partners and managers must become involved early and often in the audit process. In today's construction environment, your judgment, knowledge, and experience are even more important than they were in the past.

.74 During the past several months, the U.S. economy has suffered significant declines and uncertainties: consumer confidence has dropped, plant closings and layoffs have increased dramatically, profit margins for many companies have slipped, and many companies have failed. Periods of economic uncertainty like

this lead to challenging conditions for companies due to potential deterioration of operating results, increased external scrutiny, and reduced access to capital. During such times, professional skepticism should be heightened and the status quo should be challenged.

Audit Planning

.75 As you prepare to conduct quarterly reviews and annual audits of construction contractors, realize that your clients may be working in a new business environment as a result of the stagnant economy. If this is the case, you must gain an understanding of this new environment to plan and perform the audit adequately. Although not all construction contractors are directly affected by the economic downturn, most in the industry will experience some indirect effects. Many clients will experience effects related to shifts in demand, collectibility of accounts receivable, or valuation of their investments.

Evaluating Audit Risks

.76 Your evaluation of audit risk should start with a good understanding of your client's business. To develop this understanding, you 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.

.77 As we mentioned in the first part of this Alert, business conditions in the construction industry vary greatly across contractor types and from region to region. The risks associated with building office buildings are different from those faced by a homebuilder; a contractor in the Northeast faces different issues than a similar contractor located on the Pacific Coast. For this reason, you must be knowledgeable about contractor types and the location in which the entity operates.

Professional Skepticism

.78 The third general audit standard stipulates that due professional care be exercised in planning and conducting an audit engagement. Due professional care requires that you exercise professional skepticism in gathering and evaluating audit evidence. Although you assume neither management dishonesty nor unquestioned honesty, you should consider the increased risk associated with the potential increases in external pressure on management during the current economic climate. For a more detailed discussion of these risks, see "Consideration of Fraud" later in this section of the Alert.

.79 ***Earnings Management Challenges.*** As a result of perceived external pressures, companies may be tempted to manage earnings by using nonrecurring transactions or through changing the method of calculating key estimates, such as reserves, fair values, or impairments. Companies may also adopt inappropriate accounting practices resulting in improper recognition or omission of financial transactions. For material nonrecurring transactions that may require special disclosure to facilitate the readers' understanding of the reported financial results, apply the guidance in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, in reporting the effects of changes in estimates. Inappropriate transactions or accounting practices that may result in errors requiring adjustments of financial statements include, for example, premature recognition of revenue, failure to appropriately accrue for contingent liabilities that are probable and estimable, and failure to record unpaid purchase invoices. Additionally, you should be particularly skeptical of fourth-quarter events that result in significant revenue recognition, loss accrual, or noncash earnings.

.80 The appropriate level of professional skepticism is needed when corroborating management's representations. Management's explanations should make business sense. Additionally, you may need to consider corroborating management's explanations with members of the board of directors or the audit committee.

.81 ***Indicators of Reporting Risk.*** Other indicators of potential increased accounting and reporting risk calling for increased professional skepticism include:

1. Liquidity matters

- The company is undercapitalized, relying heavily on bank loans and other credit, and in danger of violating loan covenants.
- The company is having difficulty obtaining or maintaining financing.
- The company is having difficulty obtaining surety credit.
- The company is showing liquidity problems.

2. Quality of earnings

- The company is changing significant accounting policies and assumptions to less conservative ones.
- The company is generating profits, but not cash flow.

3. Management characteristics

- Management's compensation is largely tied to earnings.
- The company appears vulnerable to the weakening economic conditions and management is not proactive in addressing changing conditions.
- There is a significant change in members of senior management or the board of directors.

Auditing Construction Contracts

.82 Auditors of construction contractors should recognize that the traditional balance sheet approach to auditing usually is not adequate when performing an audit of a contractor. The financial statements of a contractor are built from the financial results of individual contracts. Therefore the more effective audit approach requires you to focus on the terms, financial estimates, and results of individual contracts, rather than the contract-related balance sheet that accounts for the company as a whole.

.83 The authoritative guidance on auditing contractors is contained in the annual AICPA Audit and Accounting Guide *Construction Contractors*. Included in this Audit and Accounting Guide is Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, which is the primary authoritative accounting guidance for construction contractors.

.84 Auditing construction contractors is complex. Such businesses rely on accurate and reliable estimates to operate their business as well as to prepare financial statements. Therefore, it is critical that you gain an understanding of the contractor's significant estimates and assumptions that are used in operating the business. Remember that the audit of a construction contractor's financial statements is an audit of the contractor's ability to estimate.

.85 There are several things to consider when auditing estimates: understand the internal control structure surrounding the estimate, consider the contractor's history of accurate estimates, compare actual to budgeted figures, and review subsequent events.

.86 The Professional Issues Task Force of the AICPA has identified certain procedures to consider when performing an audit of a construction contractor. They are:

- *Read significant contracts.* This procedure may seem obvious, but it is necessary to identify the terms of the contract, any guarantees, penalties or incentives, as well as cancellation and postponement provisions. For example, reading the contract might help you identify the party responsible for additional expenses incurred as a result of weather delays.

- *Identify unique contracts.* Increase the amount of testing and professional skepticism related to these contracts because they increase the risk of improper estimates and, thus, improperly stated financial statements. If a company cannot reasonably estimate the cost or progress of a contract it should account for the contract under the completed-contract method.
- *Understand the company's cash flow and how the company will manage expenses.* In this industry, expenses are often payable prior to receiving the related cash from the contract revenue. Therefore, understanding how to realistically anticipate and manage cash flow and expenses can become critical for survival. Unfortunately, some companies win long-term contracts but cannot fund the projects long enough to realize the revenue.
- *Recognize that the length of the contract period can directly affect the quality of related estimates on contracts.* The longer the contract period, the greater the risk that an estimate will be incorrect. Also, the closer a contract is to completion, the less risk there is of an incorrect estimate. Finally, the more variables inherent in an estimate, the greater the risk that an estimate will be incorrect.
- *Confirm the terms and conditions of the contract as well as the normal billing procedures.* When confirming a receivable, strongly consider confirming the original contract price; total approved change orders; total billings and payments; retainage held and whether it accrues interest; detail of any claims, back charges, or disputes; and estimated completion date or the estimate of percentage to complete.
- *Review the unapproved change orders of significant contracts.* Change orders often arise during the life of a contract, and it is necessary to adjust estimated revenue and cost for change orders that have been approved, both as to scope and price. However, when a change order has been approved as to scope but not as to price, carefully evaluate the specific facts and circumstances prior to including the order in estimated contract revenues. To the extent that change orders are disputed or are unapproved as to both scope and price, evaluate them as claims. Generally, recognize revenue on an unapproved change order or claim only if there is verifiable evidence to support it.
- *Visit construction contract sites.* Visiting contract sites can be a very useful audit procedure. Such a visit can provide an opportunity to view the progress of a contract and confirm that the job is progressing in accordance with the plans, specifications, and terms of the contract. Appropriate site visits might include significant contract sites in which the work is in the very early stages of the contract. Such a visit may help you identify the complexities of performing the contract. The site visit may also provide you with the opportunity to interview operational personnel and to gain a better understanding of the responsibility the company has for performing the contract. At the site visit, it also might be helpful to speak with available subcontractors to get additional information about the progress of the contract. Furthermore, you should consider observing equipment and uninstalled inventory at the site.
- *Meet with project managers.* Project managers play an important role in controlling and reporting job site costs. They are also close to the facts and are likely to get prompt and accurate information related to particular contracts. Meeting with the project managers will also assist you in developing your plans for performing analytical procedures.
- *Identify and understand the significant assumptions and uncertainties.* This procedure is fundamental to performing an effective audit of an entity using contract accounting.
- *Test contract costs to make sure that costs are matched with appropriate contracts.* In some instances companies may shift costs from unprofitable contracts to profitable ones in order to defer losses.
- *Audit estimated costs to complete.* The focus should be on the key factors and assumptions, such as those that (1) are significant to the estimate, (2) are sensitive to variation, (3) deviate from historical patterns, and (4) are subjective and susceptible to bias or misstatement. It is also useful to review revised or updated estimates of costs to complete and compare estimates with actual costs incurred after the balance sheet date.

- *See that losses are recorded as incurred*, regardless of whether the entity is using the percentage-of-completion or the completed-contract method of recognizing revenue.
- *Analytically review contracts completed and in progress*. A detailed analytical review of completed contracts and contracts in progress will provide meaningful information as you focus your efforts on potential problem areas.
- *See that there are appropriate disclosures* relating to SOP 94-6, *Disclosure of Risks and Uncertainties*. Entities using contract accounting should have more than generic disclosure about the use of significant estimates in the preparation of financial statements.
- *Review the aging of receivables on contracts*. This procedure will provide evidence that the company is collecting funds on a timely basis.

Although all of the above procedures are important, you should use your professional judgment in designing procedures specific to your particular clients and their contracts.

Long-Lived Assets, Including Goodwill and Intangibles

.87 Industry downturns and cash flow erosion may indicate an impairment of fixed assets, goodwill, or other intangibles. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, provides guidance in this area. In that regard, significant idle equipment or assets no longer used in operations may need to be written off.

.88 FASB Statement No. 142, *Goodwill and Other Intangible Assets*, was issued in June 2001. This Statement requires that goodwill be tested for impairment at least annually using a two-step process that begins with an estimation of the fair value of a reporting unit. The first step is a screen for potential impairment, and the second step measures the amount of impairment, if any.

.89 In addition, FASB Statement No. 142 provides specific guidance on testing intangible assets that are not being amortized for impairment and thus removes those intangible assets from the scope of other impairment guidance. Intangible assets that are not amortized are tested for impairment at least annually by comparing the fair values of those assets with their recorded amounts.

Debt

.90 You should carefully review loan agreements and test for compliance with loan covenants. In this regard, consider any “cross default” provisions, that is, a violation of one loan covenant that affects other loan covenants. Keep in mind that any debt with covenant violations that are not waived by the lender for a period of more than one year from the balance sheet date may need to be classified in the balance sheet as a current liability.

.91 As always, review the debt payment schedules and consider whether the company has the ability to pay current debt installments or to refinance the debt if necessary. When making an evaluation, it is important to remember that it is quite possible the company will not generate as much cash flow as it did in previous years.

Going Concern

.92 Continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. During the current economic situation, you should have a heightened sense of awareness of the company’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), as amended, addresses your responsibilities to evaluate whether there is substantial doubt about the

entity's ability to continue as a going concern. Negative trends, loan covenant violations, and legal proceedings might be indicators that there could be substantial doubt about the ability of the entity to continue as a going concern.

.93 Many contractors are seeing very large increases in their insurance rates. Some contractors cannot obtain commercial general liability insurance or find that it is available only from one or a few carriers. Such situations will affect the contractor who has a long-term contract bid initiated when the insurance rates were lower. You should question the going concern assumption for a contractor who cannot obtain insurance.

.94 When evaluating management's plans to continue as a going concern, an appropriate level of professional skepticism is important. For example, the company's assumptions to continue as a going concern should be scrutinized to assess whether they are based on overly optimistic or "once-in-a-lifetime" occurrences.

Job Performance

.95 It is difficult for contractors to be profitable when projects are not completed on time. A number of contracts may even require the contractor to pay penalties if the job is not completed by a specified date. Jobs that are significantly behind their established timetable may require additional audit attention and procedures to determine that the original estimates of gross profit have not deteriorated (called *profit fade*) and that the job has not incurred a loss (which should be recognized immediately).

.96 The tight labor market and the difficulty in scheduling subcontractors may result in your clients failing to complete jobs according to their preestablished timetables. For example, in these times of layoffs and increased turnover, if a key operational employee leaves the company before the job is completed, it may require some time to find a competent replacement. A number of contractors may be forced to use less experienced personnel in certain positions, including management, and that lack of experience can result in the job taking longer to complete than originally anticipated.

.97 In reviewing your client's contracts, be alert to problems caused by employee turnover or lack of adequate staffing. If your client has lost a key employee or seems to lack enough personnel to complete the projects it has committed to, consider making inquiries of management to determine how the client has factored these circumstances into the estimation process.

.98 A disruption in the supply of key materials can also affect the ability of the contractor to complete the project on time. During the past year, most construction materials were in adequate supply. However, the events of recent years have shown that an unexpected or continuing surge in demand for materials can quickly outpace supply and create shortages and delays. Additionally, the lead time required for specifically fabricated items may affect the contractor's ability to deliver the project on time.

.99 You might consider performing procedures to identify price hikes in your client's vital materials. Determine whether those price hikes are the result of inadequate supply. If so, assess your client's vulnerability to delays caused by the inability to obtain these materials on a regular and timely basis. Make inquiries to discover what steps the client has taken to mitigate these risks.

Estimating Costs to Complete

.100 A contractor's ability to estimate job costs is critical both from an operational and a financial reporting standpoint. Contractors that cannot accurately estimate job costs will be unable to manage their working capital and maintain consistent levels of profitability over an extended period of time. For most contractors, the estimate of costs to complete a project is the fuel to drive revenue recognition. For that reason, inaccurate or unsupported estimates of costs to complete jobs in progress can result in materially misstated financial statements.

.101 When auditing construction estimates, you should be familiar with SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), the AICPA Practice Aid *Auditing Estimates and Other Soft Information*, and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

.102 Management is responsible for making estimates included in the financial statements, and those estimates may be based in whole, or in part, on subjective factors such as judgment based on experience about past as well as current events and about expected conditions. In the current economic environment there is more pressure on management to accelerate profits (by underestimating the costs to complete, for example), and estimates may be difficult for auditors to audit. Pay close attention to the underlying assumptions used by management when auditing accounting estimates. Remain alert to the possibility of management's overreliance on estimates based on past favorable conditions to predict future outcomes.

Help Desk—Marshall and Swift is a consulting firm that provides comprehensive cost data for the construction industry. Included on its Web site is a cost estimator that allows the user to estimate the cost of a project based on current costs in the user's geographic area. You may find these estimates helpful in performing analytical procedures on client estimates. You can access the cost estimator at www.construction.com.

Accounting Systems and Controls

.103 Companies that expand quickly frequently outgrow the capabilities of their accounting systems and controls. Contractors with a large backlog and demand for their work tend to focus primarily on completing existing projects and bidding on new ones. Little thought may be given to whether the accounting system and related controls are capable of handling the new volume of business. In the current environment, this problem is exacerbated by either or both the lack of sufficient staffing and the high turnover of employees. It is important to consider the effects of the particular accounting systems and controls in the operation of your client's business.

.104 When clients rely on technology to manage and analyze information, audit strategies change. For example:

- Audit evidence that previously existed in paper form may be available electronically only. Accessing electronic audit evidence may require you to become proficient in the use of data extraction or other audit software tools.
- The design and operation of internal control in a computer environment is much different than in a predominately manual environment.

.105 As more construction contractors expand their use of information technology, be aware of the unique audit issues in a highly computerized environment. In addition, if your client is contemplating or in the process of making a transition from a highly manual environment to a more computerized operating environment, you should identify the risks of material misstatement that can arise during the process.

.106 For further information and guidance on auditing in this paperless environment, see SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

Consideration of Fraud

.107 Recently, the Auditing Standards Board (ASB) issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), which supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, and amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230), and SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333).

.108 SAS No. 99 addresses the following issues:

- Description and characteristics of fraud
- The importance of exercising professional skepticism
- Discussion among engagement personnel regarding the risks of material misstatement due to fraud
- Obtaining the information needed to identify risks of material misstatement due to fraud
- Identifying risks that may result in a material misstatement due to fraud
- Assessing the identified risks after taking into account an evaluation of the entity's programs and controls
- Responding to the results of the assessment
- Evaluating audit evidence
- Communicating about fraud to management, the audit committee, and others
- Documenting the auditor's consideration of fraud

For more information on SAS No. 99, see the discussion in the "Recent Auditing and Attestation Pronouncements and Other Guidance" section later in this Alert.

.109 Some examples of fraud risk factors that may exist in the construction industry include the following:

- Fraudulent financial reporting, including the following:
 - A willingness to shift costs between completed and uncompleted contracts or to use other techniques to manipulate percentage-of-completion estimates
 - Excessive under- or over-billings on individual jobs
 - A high number of contract performance problems
 - A significant portion of employees' or owners' compensation represented by bonuses, the value of which is contingent on the contractor achieving unduly aggressive financial targets
- Misappropriation of assets, including the following:
 - Tools, equipment, and supplies that are susceptible to misappropriation
 - Lack of management review and control over disbursements such as payroll or material purchases that can be used to misappropriate cash

The general state of the economy may raise several fraud risk factors. For example, the biggest fraud risk factor to consider is whether management may be under significant pressure to intentionally underestimate the costs to complete contracts in order to accelerate income. At the same time, other fraud risk factors for management might include pressure to obtain additional capital, to obtain additional bonding capacity, or to maintain debt covenants at their stated levels.

Affiliated Entities

.110 In the construction industry, contractors frequently participate in joint ventures or have a direct or indirect affiliation with other entities. The prevalence of such arrangements in the industry can be attributed to factors such as legal liability, taxation, competition, ownership and operating arrangements, labor and labor union considerations, and regulatory requirements. As a result of these types of relationships among entities, construction firms are frequently involved in related-party transactions as that term is defined in FASB Statement No. 57, *Related Party Disclosures*. Review your contractor client's participations in joint

ventures to evaluate whether investments in joint ventures are reported properly. You should also review joint venture agreements and document your client's participation.

.111 The audit considerations for a contractor's participation in a partnership are similar to those for participation in a corporate joint venture. Partner participation may differ primarily in relation to the contractor's unlimited liability as a general partner for partnership obligations.

.112 For any type of venture, remember to consider the nature of the venture, the scope of its operations, and the extent of involvement of each participant.

.113 The FASB has issued an exposure draft of an interpretation that will affect the consolidation of certain entities. See the discussion of the proposed FASB Interpretation *Consolidation of Certain Special-Purpose Entities* in the "On the Horizon" section of this Alert.

Using Hedging Transactions to Manage Risk

.114 Many construction contractors enter into hedging transactions to manage various risks. The most common risks that lend themselves to hedging strategies include those related to interest rate or foreign currency exposures. Construction contractors may also enter into weather derivative contracts (that is, contracts indexed to climatic or geological variables). Emerging Issues Task Force (EITF) Issue No. 99-2, *Accounting for Weather Derivatives*, prescribes the accounting treatment for weather derivatives.

.115 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, provides the primary guidance on accounting for hedging transactions. In addition, SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides guidance on auditing hedging transactions. The AICPA's Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* provides practical guidance for implementing SAS No. 92 on all types of audit engagements. The Guide includes an overview of derivatives and securities and how various entities use them, a summary of accounting guidance, and a discussion of the three elements of the auditing framework (inherent risk, control risk, and substantive procedures). Additionally, the Guide includes practical illustrations and case studies.

.116 If your client holds derivative instruments or engages in hedging transactions, you should become thoroughly familiar with the relevant authoritative accounting and auditing literature.

Audit and Accounting Issues of Continuing Importance

Revenue Recognition

.117 In December 1999, the SEC released Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*.¹ SAB No. 101 most directly affects financial statement preparers and auditors of public construction companies. However, auditors of nonpublic companies may also find the information contained in SAB No. 101 useful. The release of SAB No. 101 sends an important message to financial statement preparers and their auditors that revenue recognition matters will continue to draw the scrutiny of regulators.

Help Desk—In October 2000 the SEC staff provided answers to frequently asked questions about the implementation of SAB No. 101. You can find SAB No. 101 and related frequently asked questions on the SEC Web site at www.sec.gov.

¹ Staff Accounting Bulletins (SABs) are not rules or interpretations of the Securities and Exchange Commission. Rather, they represent interpretations and practices followed by the Office of the Chief Accountant and the Division of Corporate Finance in administering the disclosure requirements of the federal securities laws.

.118 As noted previously in this Alert, SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, provides guidance on revenue recognition for construction contractors. SOP 81-1 requires a contractor to use the percentage-of-completion method for recognizing revenue whenever it can produce reasonably dependable estimates. There is a rebuttable presumption that management can make reasonable estimates.

.119 The completed-contract method should be used only in instances in which reasonable, dependable estimates of construction costs cannot be made. The completed-contract method may also be used if there are no material differences between that method and the percentage-of-completion method. Situations in which there are no material differences may occur when a contractor performs primarily short-term contracts, for example, a small plumbing contractor whose projects are completed in such a short time span that the work is somewhat analogous to the manufacture of shelf production items for sale.

.120 The revenue recognition method should be disclosed in the financial statements. If the percentage-of-completion method is used, the financial statements should disclose the method of computing percentage-of-completion (for example, cost-to-cost). If the completed-contract method is used, the reason for selecting the method should be indicated.

.121 The issuance of SAB No. 101 did not affect the guidance for revenue recognition contained in SOP 81-1.

Asset Impairment

.122 Even though specific markets of the construction industry remain healthy, others are in recession. For that reason, you should continue to be alert for the possible impairment of long-lived assets.

.123 FASB Statement No. 144 provides the primary guidance on accounting for the impairment of long-lived assets. In general, the accounting for the impairment of these assets depends on whether the property is to be held and used or held for disposal. Projects under development are accounted for in the same manner as those held for investment. FASB Statement No. 144 does not provide exceptions for assets subject to nonrecourse debt.

Assets Held and Used

.124 Assets held for use should be reported at cost, less accumulated depreciation, and should be evaluated for impairment if facts and circumstances indicate that impairment may have occurred. Conditions or events such as the following may indicate a need for assessing the recoverability of assets:

- A dramatic change in the manner in which an asset is used
- A reduction in the extent to which an asset is used
- Forecasts showing lack of long-term profitability
- A change in the law or business environment
- A substantial drop in the market value of an asset

.125 If events and 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 loss 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.

.126 Lack of an asset-impairment evaluation system may indicate a material weakness in an entity's internal controls. Further, a lack of documentation generally increases the extent to which you must apply professional judgment in evaluating the adequacy of management's writedowns.

Assets to Be Disposed Of

.127 Assets to be disposed of (assets for which management has committed to a plan of disposal) should be reported at the lower of the 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.

.128 Although some assets previously might have been subject to APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, FASB Statement No. 144 amended APB Opinion No. 30. The provisions of FASB Statement No. 144 apply to all long-lived assets. Therefore, discontinued operations are no longer measured on a net realizable value basis, and future operating losses are no longer recognized before they occur.

Recent Auditing and Attestation Pronouncements and Other Guidance

.129 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, the *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 95	<i>Generally Accepted Auditing Standards</i>
SAS No. 96	<i>Audit Documentation</i>
SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i>
SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>
SSAE No. 11	<i>Attest Documentation</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i>
SQCS No. 6	<i>Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>
Audit Guide	<i>Service Organizations: Applying SAS No. 70, as Amended</i>
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i>
Questions and Answers	<i>FAQs on Sustainability Reporting</i>

Audit Interpretation No. 4 of SAS No. 70	"Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls"
Audit Interpretation No. 5 of SAS No. 70	"Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods"
Audit Interpretation No. 6 of SAS No. 70	"Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor's Engagement"
Audit Interpretation No. 14 of SAS No. 58	"Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing"
Audit Interpretation No. 12 of SAS No. 1, section 420	"The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Change in the Year of Adoption"
Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Audit Risk Factors	A detailed list of "risk factors" that should be considered as businesses prepare their 2001 financial statements
Practice Alert 02-1	<i>Communications With the Securities and Exchange Commission</i>
Practice Alert 02-2	<i>Use of Specialists</i>
Practice Alert 02-3	<i>Reauditing Financial Statements</i>
Practice Aid	<i>Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users</i>

.130 The following summaries of auditing standards might have particular significance to the construction industry. The summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standards. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 95, *Generally Accepted Auditing Standards*

.131 In December 2001, the ASB issued SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150), which supersedes section 150, *Generally Accepted Auditing Standards*, of SAS No. 1. SAS No. 95 is effective for audits of financial statements for periods beginning on or after December 15, 2001.

.132 SAS No. 95 establishes a hierarchy of generally accepted auditing standards (GAAS) consisting of auditing standards, interpretive publications, and other auditing publications.

- *Auditing standards* are comprised of the general, fieldwork, and reporting standards approved and adopted by the AICPA membership, as amended by the ASB, as well as the SASs. The auditor should be prepared to justify departures from the SASs.
- *Interpretive publications* consist of auditing Interpretations of the SASs, auditing guidance included in the AICPA Audit and Accounting Guides, and AICPA auditing SOPs. The auditor should be aware of and consider applicable interpretive publications. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.
- *Other auditing publications* include AICPA auditing publications not referred to above as well as auditing articles in the *Journal of Accountancy* and other professional journals; auditing articles in the *AICPA CPA Letter*; continuing professional education programs and other instruction materials; textbooks; and so forth. Although other auditing publications have no authoritative status, they may help the auditor understand and apply the SASs.

The auditor is not expected to be aware of the full body of other auditing publications. However, if you apply the auditing guidance included in an other auditing publication, you must determine that such guidance is appropriate and relevant. If the guidance has been reviewed by the AICPA Audit and Attest Standards team it is presumed to be appropriate.

SAS No. 96, *Audit Documentation*

.133 In January 2002, the ASB issued SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339). SAS No. 96 supersedes SAS No. 41, *Working Papers*, and amends three SASs. SAS No. 96 is effective for audits of financial statements for periods beginning on or after May 15, 2002. Earlier application is permitted.

.134 Among other things, SAS No. 96 supersedes SAS No. 41 by using the term audit documentation instead of working papers to describe the principal record of auditing procedures applied, evidence obtained, and conclusions reached by the auditor in an audit engagement. (Note, however, that SAS No. 96 permits the term working papers to be used to refer to audit documentation.)

.135 In addition to superseding SAS No. 41, SAS No. 96 amends the following:

- SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)
- SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329)
- 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. 98, *Omnibus Statement on Auditing Standards—2002*

.136 In September 2002, the ASB issued SAS No. 98, *Omnibus Statement on Auditing Standards—2002* which, among other things:

1. Amends SAS No. 95 (AU sec. 150.05) to clarify the status of appendixes to SASs as being interpretive publications. This amendment is effective upon issuance.
2. Amends SAS No. 25, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 161.02 and .03), to clarify the relationship between Statements on Quality Control Standards (SQCSs) and engagements performed under SASs. This amendment is effective upon issuance.

3. Amends SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU sec. 312.34–41), to clarify the auditor's responsibility with respect to evaluating audit adjustments. This amendment is effective upon issuance.
4. Amends SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), and rescinds Interpretation No. 6, "Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor's Engagement," of SAS No. 70.
5. Amends SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.65), to make the guidance in SAS No. 58 consistent with the guidance in section 530 of SAS No. 1 (AU sec. 530.01) by using the term *completion of fieldwork* as opposed to "completion of his most recent audit." This amendment is effective upon issuance.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*

.137 SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, and amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230), and SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333).

.138 The Statement does not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor*, paragraph .02.² However, SAS No. 99 establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.³

.139 Among other things, SAS No. 99 also includes Exhibit 1, "Management Anti-Fraud Programs and Controls," which was developed to assist auditors in obtaining an understanding of programs and controls that management may use to mitigate specific risks of fraud, or that otherwise help to prevent, deter, and detect fraud.

.140 SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application is permissible.

.141 The AICPA is working on a fraud Practice Aid titled *Fraud Detection in a GAAS Audit—An Auditor's Field Guide* that will be published by the end of 2002. Among its many topics, the Practice Aid addresses topics such as how the new SAS changes audit practice, characteristics of fraud, understanding the new SAS, best practices, and practice aids, including specialized industry fraud risk factors, common frauds, and extended audit procedures. Auditors should be on the lookout for this new *Auditor's Field Guide*.

² The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). 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 (see SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), or fraud.

³ Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statements in accordance with generally accepted auditing standards (GAAS). Chapter 1, "Attest Engagements," of Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101), and Statement on Standards for Consulting Services (AICPA, *Professional Standards*, vol. 2, CS sec. 100) provide guidance to accountants relating to the performance of such services.

SQCS No. 6, *Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice*

.142 In September 2002, the ASB issued Statement on Quality Control Standards (SQCS) No. 6, *Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards*, vol. 2, QC sec. 20). This Statement amends SQCS No. 2 to clarify that deficiencies in individual audit, attest, compilation, and review engagements do not, in and of themselves, indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards. This amendment is effective upon issuance.

SSAE No. 11, *Attest Documentation*

.143 This amendment to Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT secs. 101–701), reflects the concepts and terminology used in SAS No. 96, *Audit Documentation*.

.144 This amendment is effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002. Earlier application is permitted.

SSAE No. 12, *Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification*

.145 Issued in September 2002, this amendment to SSAE No. 10 (AT sec. 101.17–18) clarifies the relationship between SQCSs and engagements performed under SSAEs. The amendment clarifies that, although an effective quality control system is conducive to compliance with attestation standards, deficiencies in or noncompliance with a firm's quality control system do not, in and of themselves, indicate that an engagement was not performed in accordance with the applicable professional standards. This amendment is effective upon issuance.

Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*

.146 This Guide (product no. 012772kk) provides guidance to service auditors engaged to issue reports on a service organization's controls that may be part of a user organization's information system in the context of an audit of financial statements. The Guide also provides guidance to user auditors engaged to audit the financial statements of entities that use service organizations. Guidance on performing service auditors' engagements and using service auditors' reports in audits of financial statements is provided in SAS No. 70.

Related-Party Toolkit

.147 The AICPA staff has developed an electronic document, *Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors*, to provide accountants and auditors of private-sector business enterprises with an overview of selected authoritative accounting and auditing literature, SEC requirements, and nonauthoritative best practice guidance concerning related parties and related-party transactions. In these current economic times when management needs to be more sensitive to independence and related-party issues and possible conflicts between the entity and parties with which it does business, identifying related parties and related-party transactions is an important aspect of a financial statement audit.

Help Desk—The related-party toolkit is available on the AICPA Web site at aicpa.org/public/download/news/relpty_toolkit.doc.

Audit Risk Factors

.148 In January 2002, the five largest accounting firms and the AICPA released a detailed list of “risk factors” to consider as businesses prepared their 2001 financial statements. Among the specific financial reporting issues addressed by the risk assessment document are liquidity and viability (going concern), changes in internal control, unusual transactions, related parties, off-balance sheet arrangements, materiality, and adequate disclosure. The document also recommends actions that can be taken to address such financial reporting risks.

Help Desk—The risk assessment document is available on the AICPA Web site at aicpa.org/public/download/news/risk_factor.doc.

Accounting Pronouncements and Guidance Update

.149 Presented below is a list of recently issued accounting pronouncements and other guidance issued since the publication of last year’s Alert. See the AICPA *Audit Risk Alert—2002/03* [AAM section 8010] for a summary explanation of these issuances. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy*.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13 and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated with Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions</i>
SOP 01-5	<i>Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</i>
SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i>

On the Horizon

Proposed SOP Related to Property, Plant, and Equipment

.150 The Accounting Standards Executive Committee (AcSEC) of the AICPA issued a proposed SOP, *Certain Costs and Activities Related to Property, Plant, and Equipment*, that will address accounting and disclosure issues related to determining which costs related to assets should be capitalized as improvements and which should be expensed as repairs and maintenance. The SOP also will address capitalization of indirect and overhead costs. The proposed SOP is expected to provide guidance on “componentization” of assets, in which the asset is separated into separate components each of which may have different useful lives. Each component would be accounted for and depreciated or amortized as a separate asset.

.151 In general, the SOP uses a “project stage” framework, in which accounting guidance is provided for each stage in the property, plant, and equipment (PP&E) project. The stages would include *preliminary* (occurring before acquisition of specific PP&E is deemed probable), *preacquisition* (occurring after acquisition of specific PP&E is deemed probable, but before actual acquisition or construction), *acquisition or construction*, and *in service* (beginning at the time acquisition or construction is substantially complete and the PP&E is ready for its intended use).

.152 The exposure draft contains the following conclusions:

- Except for the cost of options, preliminary stage costs would be charged to expense as incurred.
- Costs related to PP&E incurred during the acquisition-or-construction stage would be capitalized if the costs are directly identifiable with the specific PP&E. Directly identifiable costs include only:
 - Incremental direct costs of acquiring, constructing, or installing the PP&E incurred in transactions with independent third parties for the specific PP&E.
 - Certain costs directly related to specified preacquisition activities performed by the entity for the acquisition, construction, or installation of the specific PP&E.
- General and administrative costs and overhead costs would be charged to expense as incurred. Similar conclusions would apply to preacquisition stage costs.
- Costs related to PP&E that are incurred during the in-service stage, including costs of normal, recurring, or periodic repairs and maintenance activities, would be charged to expense as incurred unless the costs are incurred for (1) the acquisition of additional PP&E or components of PP&E, or (2) the replacement of existing PP&E or components of PP&E. Removal costs would be charged to expense as incurred.
- The costs of planned major maintenance activities would not be a separate PP&E component. Those costs would be capitalized to the extent they are capitalizable under the in-service stage guidance of the SOP and represent additions or replacements, and they would otherwise be charged to expense as incurred.
- A component would be a tangible part or portion of PP&E that (1) can be separately identified as an asset and depreciated over its own expected useful life and (2) is expected to provide economic benefit for more than one year. If a component has an expected useful life that differs from the expected useful life of the PP&E asset to which it relates, the cost would be accounted for separately and depreciated or amortized over its expected useful life.
- If an entity replaces a part or portion of a PP&E asset that has not been previously accounted for as a separate component, and the replacement meets the definition of a component, the entity would capitalize the replacement, account for it as a separate component going forward, estimate the net book value of the replaced item, and charge the net book value of the replaced item to expense in the period of replacement.

Proposed FASB Interpretation *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*

.153 In an effort to improve disclosures about loan guarantees, the FASB has issued an exposure draft of a proposed Interpretation, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*.

.154 The proposed Interpretation would clarify and expand on existing disclosure requirements for guarantees, including loan guarantees. It also would require that at the time a company issues a guarantee, it must recognize a liability for the fair value, or market value, of its obligations under that guarantee. By improving its disclosures and accounting, a company provides a more representationally faithful picture of its financial position and the risk it has assumed.

.155 The Interpretation does not address the subsequent measurement of the guarantor's recognized liability over the term of the guarantee. It also would incorporate, without change, the guidance in FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others*, which is being superseded.

.156 This guidance would not apply to guarantee contracts issued by insurance companies, a lessee's residual value guarantee embedded in a capital lease, contingent rents, and price rebates. The provisions related to recognizing a liability at inception for the fair value of the guarantor's obligations would not apply to product warranties or to guarantees accounted for as derivatives.

Proposed FASB Interpretation *Consolidation of Certain Special-Purpose Entities*

.157 The FASB has issued an exposure draft of a proposed Interpretation that establishes accounting guidance for consolidation of special-purpose entities (SPEs). The proposed Interpretation, *Consolidation of Certain Special-Purpose Entities*, will apply to any business enterprise—whether public or private—that has an ownership interest, contractual relationship, or other business relationship with an SPE. The proposed guidance would not apply to not-for-profit organizations.

.158 The objective of this proposed Interpretation is to improve financial reporting by enterprises involved with SPEs—not to restrict the use of SPEs. However, it is expected that when this proposal is implemented, more SPEs will be consolidated than in the past. Most SPEs serve valid business purposes, for example, by isolating assets or activities to protect the interests of creditors or other investors, or to allocate risks among participants. SPEs that were unconsolidated prior to this proposed Interpretation were reported according to the guidance and accepted practice that existed prior to this proposed Interpretation.

.159 Current accounting standards require an enterprise to include subsidiaries in which it has a controlling financial interest in its consolidated financial statements. That requirement usually has been applied to subsidiaries in which an enterprise has a majority voting interest, but in many circumstances the enterprise's consolidated financial statements do not include SPEs with which it has fundamentally similar relationships. The reason is that existing consolidation guidance focuses primarily on parent-subsidiary relationships established through voting ownership interests, and the relationship between a business enterprise and an SPE is established through other means.

.160 The FASB believes that if a business enterprise has a controlling financial interest in an SPE, the assets, liabilities, and results of the activities of the SPE should be included in consolidated financial statements with those of the business enterprise, which is referred to as the primary beneficiary of the SPE.

.161 As to finalization of this project, the FASB expects to issue an Interpretation in the fourth quarter of this year. The accounting guidance would be effective immediately upon issuance of the Interpretation for new SPEs. Companies with SPEs that existed prior to issuance of the Interpretation would be required to apply the guidance to the existing SPEs at the beginning of the first fiscal period after March 15, 2003. Calendar year end companies would need to apply the guidance on April 1, 2003.

AICPA Resource Central

.162 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your construction engagements (product numbers appear in parentheses).

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (012510kk)
- Audit Guide *Audit Sampling* (012530kk)
- Audit Guide *Analytical Procedures* (012551kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (010010kk)
- *Accounting Trends & Techniques—2002* (009894kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (006701kk)

Audit and Accounting Manual

.163 The *Audit and Accounting Manual* (product no. 005132kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. The Manual contains numerous practice aids, samples, and illustrations, including audit programs, auditors' reports, checklists, and engagement letters, management representation letters, and confirmation letters.

AICPA reSOURCE Online: Accounting and Auditing Literature

.164 Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, *Audit and Accounting Guides* (more than 20!), *Audit Risk Alerts* (more than 15!) and *Accounting Trends & Techniques*. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Educational Courses

.165 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the construction industry. Those courses include the following (product numbers are in parentheses):

- *AICPA's Annual Accounting and Auditing Workshop* (2002-2003 edition) (737082kk, text; 187082, video). Whether you are in industry or public practice, this course keeps you current and informed, and shows you how to apply the most recent standards.
- *The AICPA's Guide to Consolidations and Business Combinations* (735125kk). Learn how FASB Statements No. 141 and No. 142 have changed the rules for business combinations and goodwill accounting.
- *Auditing in a Paperless Society* (730121kk). Now that paper is slowly diminishing, where do you go? This course will teach you how to develop strategies for auditing around, through, and with a computer.
- *Real Estate Accounting and Auditing* (730600kk). This course provides an in-depth study of the unique requirements that apply at each stage of the real estate life cycle.

Online CPE

.166 The AICPA offers an online learning tool entitled *AICPA InfoBytes*. An annual fee (\$119 for members and \$319 for nonmembers) offers unlimited access to hundreds of hours of CPE content in one- and two-credit courses. Register today as our guest at www.cpa2biz.com/infobytes.

CPE CD-ROM

.167 *The Practitioner's Update* (product no. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

.168 To order AICPA products, receive information about AICPA activities, and find help on your membership questions call the AICPA Member Satisfaction Center at (888) 777-7077.

Technical Hotline and Ethics Hotline

.169 Do you have a complex technical question about GAAP, other comprehensive basis of accounting (OCBOA), accounting, auditing, compilation engagements, review engagements, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with an answer. You can reach the Technical Hotline at (888) 777-7077.

.170 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

Conference

.171 Among the many interesting conferences the AICPA offers, there is one that might interest you and your construction industry clients. The conference, held late each fall, is the "AICPA National Construction Industry Conference," which presents a comprehensive program revealing latest trends and developments in the construction industry. The conference offers a national perspective and addresses the newest trends in conducting business, among other topics.

.172 For additional information, contact CPA2Biz at its Web site, www.cpa2biz.com.

Web Sites⁴

AICPA Online and CPA2Biz

.173 Here is a unique opportunity to stay abreast of matters relevant to the CPA profession! AICPA Online, at www.aicpa.org, informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, CPA2Biz, at www.cpa2biz.com, offers you all the latest AICPA products, including more than 15 Audit Risk Alerts, more than 20 Audit and Accounting Guides, the professional standards, and CPE courses.

.174 This Audit Risk Alert replaces *Construction Contractors Industry Developments—2001/02*. *Construction Contractors 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 appreciated. You may e-mail these comments to lgivarz@aicpa.org or write to:

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⁴ Additional helpful Web sites are presented in the Appendix.

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Appendix

The Internet—An Auditor's Research Tool

Here are some useful Web sites that may provide valuable information as you plan your client engagements. In addition to these Web sites, be sure to review those listed in the "On the Horizon" section of this Alert.

General Web Sites of Interest

<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	www.aicpa.org
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
<i>The Electronic Accountant</i>	World Wide Web magazine that features up-to-the-minute news for accountants	www.electronicaccountant.com
AuditNet	Electronic communications among audit professionals	www.cowan.edu.au/mra/home.htm
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com/
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com/
<i>Double Entries</i>	A weekly newsletter on accounting and auditing around the world	www.csu.edu.au/lists.anet/ADBLE-L/index.html
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
Federal Reserve Bank of New York	Key interest rates	www.ny.frb.org/pihome/statistics/dlyrates
Cybersolve	Online financial calculators, such as ratio and breakeven analysis	www.cybersolve.com/tools1.html
FedWorld.Gov	U.S. Department of Commerce-sponsored site providing access to government publications	www.fedworld.com
Hoovers Online	Online information on various companies and industries	www.hoovers.com
Ask Jeeves	Search engine which uses a user-friendly question format, and provides simultaneous search results from other search engines as well (for example, Excite, Yahoo, AltaVista)	www.askjeeves.com
Vision Project	Information on the profession's Vision project	www.cpavision.org/horizon

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	www.kentis.com/ib.html
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
Society of Industrial and Office Realtors	Industrial and office real estate information	www.sior.com
<i>Engineering News Record</i>	Source of important information for owners, contractors, and design and engineering professionals	www.enr.com
Construction.com	A McGraw-Hill company that unifies the resources of Dodge, Sweets, <i>Architectural Record</i> , ENR, and Regional Publications and includes market analysis and forecasting, industry trends, and insights	www.construction.com

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AAM Section 8100

Investment Companies Industry Developments—2002/03

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your investment companies industry audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the investment companies industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010]. You should refer to the full text of the accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this Alert.

Economic and Industry Developments

.04 Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), among other matters, provides guidance for auditors regarding the specific procedures that should be considered in planning an audit in accordance with generally accepted auditing standards (GAAS). SAS No. 22 states that the auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics, and consider matters affecting the industry in which the entity operates, including, among other matters, economic conditions as they relate to the specific audit.

.05 Also, paragraph 2.99 in the Audit and Accounting Guide *Audits of Investment Companies* states that economic conditions in the jurisdictions in which funds invest may affect the auditor's assessment of inherent risk for assertions in investment companies' financial statements. Factors that auditors should consider include local rates of inflation, government stability, and local tax rules. Auditors should consider whether such indicators create, intensify, or mitigate inherent risk.

Economic Developments

.06 For a thorough discussion of the economic and business environment, see the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

The U.S. Economy in Recovery

.07 Investment companies operated and invested through the first three quarters of 2002 in an economy in recovery from the recession experienced in 2001. The economic word for 2001 was *uncertain*, and that continues to hold true for 2002. The current mix of opposing trends—solid demand, but no strong pickup in jobs—stems partly from the nature of this business cycle. In other words, mild recoveries tend to follow mild recessions.

.08 Some matters in the forefront during the first three quarters of 2002 were allegations of fraudulent financial reporting, employee layoffs, increased government regulation and security procedures resulting from terrorism concerns, and weak corporate profits reported in some business sectors. Some of the other economic developments of 2002 are presented in this section of the Alert.

The Equities Markets

.09 Activity in the U.S. equities markets through the first three quarters of 2002 was volatile. The Dow Jones Industrial Average (DJIA), Standard and Poor's (S&P) 500 Index, and National Association of Securities Dealers Automated Quotation (NASDAQ) composite continued their declines of the two previous years.

Low Interest Rates

.10 Interest rates have remained low. Following a number of cuts by the Federal Reserve Board in 2001, the federal funds rate stayed at 1.75 percent through much of 2002, until the rate was cut again in November 2002, to 1.25 percent. Many homeowners took advantage of the opportunity provided by lower interest rates and refinanced their mortgages.

Consumer Spending

.11 Consumer spending, which accounts for two-thirds of U.S. economic output, has remained strong through the first half and into the third quarter of 2002, fueled by demand for new automobiles and a strong housing market.

Fund Performance

.12 Through the first three quarters of 2002, there was not a lot of good news to be found when looking at fund performance. Investors in stock funds, accustomed to double- and even triple-digit gains in recent years, were now seeing negative returns, more frequently in the double digits. Investors saw these negative returns across a wide range of funds—growth funds, as well as value funds, large cap as well as small-cap funds, diversified funds, and many sector funds, among others.

.13 The news, however, was better for other investment companies. A number of money market funds and bond funds, as well as some stock funds, were able to provide investors with positive returns. Also, starting in June 2002, and continuing in the third quarter, many investors began pulling out of stock funds. A number of bond funds and money market funds were the beneficiaries of investor actions away from stock funds, as investors who viewed bond and money market funds as a less riskier investment alternative to stock fund investment responded by moving their investment dollars into bond and money market funds. The continuing declines in interest rates through the year, however, highlighted by the Federal Reserve Board's half-point reduction in the discount rate in 2002, resulted in the movement of money market fund yields, after expenses, near (and in a few cases even below) zero. A number of investment advisers or sponsors of money market funds have waived fees or assumed fund expenses to maintain a positive yield to shareholders. Auditors should understand these waiver and assumption agreements and determine that they are properly accounted for and disclosed in fund financial statements.

Investing in Riskier Instruments

.14 This section of the Alert previously discussed the weak performance of many funds. Investment companies, seeking to retain investors and stem fund outflows, may be under increased pressure to find ways to improve fund performance and outperform competitors and benchmarks. Auditors should consider the possibility that investment companies, seeking higher returns for investors, may be investing in more illiquid investments, or in debt instruments that have a greater potential for default. As discussed in paragraph 2.59 of the Audit and Accounting Guide *Audits of Investment Companies*, adverse economic developments often lead to increases in the default rates of debt securities. In addition to occasional capital

infusions, professional fees to legally restructure the investments are frequently incurred by bondholders. Paragraphs 2.56 and 2.57 of the Guide note that for defaulted debt securities, in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, accrued interest should be written off when it becomes probable that the interest will not be collected and the amount of uncollectible interest can be reasonably estimated. The portion of interest receivable on defaulted debt securities written off that was recognized as interest income should be treated as a reduction of interest income. Write-offs of purchased interest should be reported as increases to the cost basis of the security, which will result in an unrealized loss. Paragraphs 2.60 and 2.61 of the Guide discuss accounting for capital infusions and workout expenditures. Auditors should also focus on the valuations of potentially distressed securities, considering the guidance in paragraphs 2.126 through 2.135.

.15 For additional discussion about auditing and accounting for investments, including valuation of investments, see “Auditing and Accounting for Investments” in the “Audit Issues and Developments” section of this Alert.

Exchange-Traded Funds

.16 In 2002, the investment companies industry continued to present new types of investment opportunities. One area where this is reflected is exchange-traded funds (ETFs). At the start of 2002, the ETFs tracked only equity indexes, such as the S&P 500, DJIA, or NASDAQ 100. In 2002, the Securities and Exchange Commission (SEC) approved an exemption application that would permit ETFs that track fixed-income indexes. Also, in November 2001, as discussed in last year’s Alert, the SEC issued the Concept Release *Actively Managed Exchange Traded Funds*, which sought comments on issues relating to actively managed ETFs. This Concept Release is available on the SEC Web site at www.sec.gov.

Pressures to Establish Cost-Cutting Measures

.17 In this weakened economic environment, increased pressures may exist to establish cost-cutting measures at investment companies and at the organizations providing services to the investment company, such as custodians, transfer agents, and administrators.

.18 Auditors of investment companies should consider the possible effects of cost-cutting measures, such as hiring freezes and employee layoffs, on internal control. Employee layoffs may result in a shortage of staff with needed skills and knowledge of the unique industry accounting and regulatory requirements, negatively affecting the ability to record, process, summarize, and report the investment company’s financial data. Responsibilities that were previously segregated may be combined, allowing for greater opportunities to conceal errors or fraud.

.19 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance on the independent auditor’s consideration of an entity’s internal control in an audit of financial statements in accordance with GAAS. In all audits, the auditor should obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements, and determine whether they have been placed in operation. The auditor then assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. Also, weaknesses in internal control that the auditor concludes constitute significant deficiencies that are reportable conditions, should be communicated to the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

.20 If an investment company uses a service organization, transactions that affect the investment company’s financial statements are subjected to controls that may be physically and operationally removed from the investment company. Consequently, the investment company’s internal control may include controls

that are not directly administered by the investment company. Planning the audit may require the auditor of the investment company to gain an understanding of controls at the service organization that may affect the investment company's financial statements. This understanding may be gained in several ways, including obtaining a service auditor's report. SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, 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, as well as guidance for independent auditors who issue reports on the processing of transactions by service organizations for use by other auditors. See the related discussion "Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*" in the "New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance" section of this Alert.

Mergers of Funds

.21 Auditors of investment companies may find their clients have been involved in a fund merger. You can find guidance about fund mergers in the section "Business Combinations" in chapter 8 of the Audit and Accounting Guide *Audits of Investment Companies*. That discussion notes that a registration statement on SEC Form N-14 is filed in connection with a fund merger. Form N-14 contains information about the companies involved in the transaction, historical financial statements, and pro forma financial statements. Form N-14 instructions, and Article 11 of Regulation S-X, as well as prior SEC "Dear CFO" letters,¹ may assist in understanding the requirements for pro forma financial statements in merger proxy statement and prospectus filings. Also, as a result of fund mergers, auditors of investment companies who may find themselves in the role of either predecessor or successor auditor should consider the guidance in SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315), as amended. SAS No. 84 provides guidance on communications between predecessor and successor auditors when a change of auditors is in process or has taken place. You should note that conforming changes were made in 2002 to the "Business Combinations" section in the Audit and Accounting Guide *Audits of Investment Companies* as a result of the issuance of FASB Statement No. 141, *Business Combinations*.

Regulatory Developments²

.22 SAS No. 22, *Planning and Supervision*, states that in planning the audit, the auditor should consider matters affecting the industry in which the entity operates as they relate to the audit, including, among other matters, government regulations. This section of the Alert provides brief summaries of some of the regulations issued and regulatory publications released since the writing of last year's Alert that may affect your clients in the investment companies industry.

SEC Regulations

.23 Some of the final rules that the SEC issued since the writing of last year's Alert are:

- *Approved information collections* (Releases No. 33-8071, No. 34-45601, No. 35-27505, No. 39-2396, No. IC-25471, and No. IA-2021). In March 2002, the SEC amended its rules concerning information collection requirements under the Paperwork Reduction Act to update the display of Office of Management and Budget control numbers associated with the SEC's collection of information. Effective date: March 27, 2002.

¹ See the discussion "SEC 'Dear CFO' Letter" in the "Regulatory Developments" section of this Alert for additional information.

² Readers should be alert for updates, amendments, or other changes to the rules discussed in this section of the Alert and other recent developments related to regulatory activities. The brief summaries provided in this section of the Alert are for informational purposes only. Readers should refer to the full text of the regulations and other documents that are discussed in this section of the Alert. The complete text of Securities and Exchange Commission (SEC) final rules discussed in this section of the Alert, rules adopted subsequent to the writing of this Alert, as well as proposed rules and other SEC information, can be obtained from the SEC Web site at www.sec.gov. See the "Information Sources" table at the end of this Alert for a list of some Web sites that can provide additional information on regulatory issues and developments.

- Registration form for insurance company separate accounts registered as unit investment trusts that offer variable life insurance policies (Releases No. 33-8088 and No. IC-25522). In April 2002, the SEC adopted a new registration Form N-6 for insurance company separate accounts that are registered as unit investment trusts and that offer variable life insurance policies. Form N-6 is to be used by these separate accounts to register under the Investment Company Act of 1940 (1940 Act) and to offer their securities under the Securities Act of 1933 (1933 Act). Form N-6 replaces Form N-8B-2 and Form S-6 for these registrants. The SEC also amended Form N-1A to require a fee table for mutual funds that offer their shares as investment options for variable life insurance policies and variable annuity contracts. Technical amendments to various rules under the 1933 Act and the 1940 Act, and to Form N-8B-2 were also adopted. Effective date: June 1, 2002. See the SEC release for compliance date information.
- *Amendment to definition of equity security* (Releases No. 33-8091 and No. 34-45769). The Commodity Futures Modernization Act of 2000 amended the definition of *security* in the 1933 Act and the definitions of *security* and *equity security* in the Securities Exchange Act of 1934 (1934 Act) to include a security future. In April 2002, the SEC amended Rule 405 under the 1933 Act and Rule 3a11-1 under the 1934 Act to include security futures in the definition of *equity security*, consistent with the statutory treatment of security futures. Effective date: June 7, 2002.
- *Exemption for the acquisition of securities during the existence of an underwriting or selling syndicate* (Release No. IC-25560). In April 2002, the SEC adopted amendments to Rule 10f-3 under the 1940 Act. Rule 10(f) under the 1940 Act prohibits a fund from purchasing any security during an underwriting or selling syndicate if the fund has certain affiliated relationships with a principal underwriter for the security. Rule 10f-3 permits a fund to purchase securities in a transaction that Section 10(f) would prohibit, if certain conditions are met. The amendments to Rule 10f-3 expand the exemption that rule provides to permit a fund to purchase U.S. government securities in a syndicated offering. Effective date: May 10, 2002.
- *Technical amendments to rules and forms due to the National Securities Markets Improvement Act of 1996 and the Gramm-Leach-Bliley Act* (Releases No. 34-46106 and No. IC-25621). In June 2002, the SEC adopted technical amendments to rules and forms under the 1940 Act and the 1934 Act to correct statutory references included in the rules and forms. Effective date: July 8, 2002.
- *Investment company mergers* (Release No. IC-25666). In July 2002, the SEC adopted amendments to expand the availability of Rule 17a-8 under the 1940 Act. The amendments permit affiliated fund mergers regardless of the reasons for the funds' affiliation, and permit mergers between funds and affiliated persons that are bank common trust funds, bank collective trust funds, and unregistered insurance company separate accounts, provided that the survivor is a registered investment company. The amendments subject the exemption to certain additional conditions designed to protect investors. Effective date: July 26, 2002. See the SEC release for compliance date information.
- *Ownership reports and trading by officers, directors, and principal security holders* (Releases No. 34-46421, No. 35-27563, and No. IC-25720). In August 2002, the SEC adopted rule and form amendments to implement the accelerated filing deadline applicable to change of beneficial ownership reports required to be filed by officers, directors, and principal security holders under Section 16(a) of the 1934 Act, as amended by the Sarbanes-Oxley Act of 2002. Effective date: August 29, 2002.
- *Certification and disclosure in companies' quarterly and annual reports* (Releases No. 33-8124, No. 34-46427, and No. IC-25722). In August 2002, the SEC adopted new rules, including new Rule 30a-2 under the 1940 Act, and rule amendments, including amendments to Rule 30b1-3 and Form N-SAR under the 1940 Act. Rule 30a-2 requires a registered investment company that files periodic reports under Section 13(a) or 15(d) of the 1934 Act to include the certification specified by Section 302 of the Sarbanes-Oxley Act of 2002 in those periodic reports. Section 302 of the Sarbanes-Oxley Act of 2002 requires the SEC to adopt final rules requiring an issuer's principal executive officer or officers and principal financial officer or officers each to certify the financial and other information contained in the issuer's quarterly and annual reports. The instructions to Form N-SAR are amended to require

the specified certification be filed as an exhibit to the form. Investment companies filing reports on Form N-SAR under sections 13(a) and 15(d) of the 1934 Act will also be required to maintain and evaluate disclosure controls and procedures under new 1934 Act rules 13a-15 and 15d-15. Effective date: August 29, 2002.

- *Acceleration of periodic report filing dates and disclosure concerning Web site access to reports* (Releases No. 33-8128 and No. 34-46464). In September 2002, the SEC adopted amendments to rules and forms to accelerate the filing of quarterly and annual reports under the 1934 Act by domestic reporting companies that have a public float of at least \$75 million, that have been subject to the 1934 Act's reporting requirements for at least 12 calendar months, and that previously have filed at least one annual report. The changes for these accelerated filers will be phased in over three years and begin for reports filed by companies that meet the definition of *accelerated filer* as of the end of their first fiscal year ending on or after December 15, 2002. The SEC also adopted amendments that require accelerated filers to disclose in their annual reports where investors can obtain access to their filings, including whether the company provides access to its forms 10-K, 10-Q, and 8-K on its Internet Web site, free of charge, as soon as reasonably practicable after those reports are electronically filed or furnished to the SEC.
- *Disclosure of costs and expenses by insurance company separate accounts registered as unit investment trusts that offer variable annuity contracts*. In November 2002, the SEC adopted amendments to Form N-4, the form used by insurance company separate accounts that are organized as unit investment trusts and that offer variable annuity contracts to register under the 1940 Act and offer their securities under the 1933 Act. The amendments revise the format of the fee table of Form N-4 to require disclosure of the range of total expenses for all of the mutual funds offered through the separate account, rather than disclosure of the expenses of each fund. Other amendments to the format and instructions for the fee table of Form N-4 were also adopted. The SEC also adopted amendments to the fee table of Form N-6, the registration form for insurance company separate accounts that are registered as unit investment trusts and that offer variable life insurance policies. The amendments require disclosure of the range of total expenses of all of the mutual funds offered, consistent with the amendments to the fee table of the registration form for variable annuities. Effective date: December 23, 2002. See the SEC release for compliance date information.

Other SEC Developments

Frequently Asked Questions About Rule 35d-1 (Investment Company Names)

.24 The staff of the SEC's Division of Investment Management has prepared responses to frequently asked questions about Rule 35d-1, which addresses certain broad categories of investment company names that are likely to mislead investors about an investment company's investments and risks. These responses to frequently asked questions are available on the SEC Web site at www.sec.gov.

Cautionary Advice Regarding the Use of "Pro-Forma" Financial Information in Earnings Releases

.25 The SEC issued Financial Reporting Release (FRR) No. 59, *Cautionary Advice Regarding the Use of "Pro-Forma" Financial Information in Earnings Releases* (Releases No. 33-8039 and No. 34-45124) in December 2001 to caution public companies on their use of pro forma financial information and alert investors to the dangers of such information.

Cautionary Advice Regarding Disclosure About Critical Accounting Policies

.26 The SEC issued FRR No. 60, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (Releases No. 33-8040 and No. 34-45149) in December 2001 to remind management, auditors, audit committees, and their advisers that were undertaking the preparation and filing of required annual reports of public companies that the selection and application of the company's accounting policies must be appropriately reasoned. The Cautionary Advice encouraged public companies to include in Management's Discussion and

Analysis (MD&A) full explanations, in plain English, of their “critical accounting policies,” the judgements and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions.

Commission Statement About Management’s Discussion and Analysis of Financial Condition and Results of Operations

.27 The SEC issued FRR No. 61, *Commission Statement About Management’s Discussion and Analysis of Financial Condition and Results of Operations* (Releases No. 33-8056 and No. 34-45321) in January 2002 to set forth certain views of the SEC regarding disclosure that should be considered by registrants in MD&A of Financial Condition and Results of Operations while preparing 2001 annual reports. The statement addresses disclosure matters concerning (1) liquidity and capital resources, including off-balance sheets arrangements, (2) certain trading activities that include non-exchange-traded contracts accounted for at fair value, and (3) effects of transactions with related and certain other parties.

Joint Order Granting the Modification of Listing Standards Requirements Under Section 6(h) of the Securities Exchange Act of 1934 and the Criteria Under Section 2(a)(1) of the Commodity Exchange Act

.28 The SEC and Commodity Futures Trading Commission (CFTC) by joint order modified the requirement specified in Section 6(h)(3)(D) of the 1934 Act, and the criterion specified in Section 2(a)(1)(D)(i)(III) of the Commodity Exchange Act, to permit an ETF share, trust-issued receipt, or share of a registered closed-end management investment company to underlie a securities future, provided certain specified criteria are met (Release No. 34-46090).

Order Pursuant to Section 11A of the Securities Exchange Act of 1934 and Rule 11Aa-32(f) Thereunder Granting a De Minimis Exemption for Transactions in Certain Exchange-Traded Funds From the Trade-Through Provisions of the Intermarket Trading System

.29 The SEC granted a de minimis exemption from the trade-through provisions of the Intermarket Trading System Plan with respect to transactions in ETFs tracking the NASDAQ-100 Index (QQQs), the DJIA (DIAMONDS), and the S&P 500 Index (SPDRs) that are effected at a price no more than three cents away from the best bid and offer quoted in the Consolidated Quote System, effective commencing on September 4, 2002 through June 4, 2003 (Release No. 46428).

SEC “Dear CFO” Letter

.30 The accounting staff of the SEC’s Division of Investment Management periodically issues a generic letter addressed to the chief financial officers of investment company registrants and their independent public accountants to assist them in addressing certain accounting-related matters. You can obtain the industry letters for December 1998, December 1999, and February 2001 on the SEC Web site at www.sec.gov.

Audit Issues and Developments³

The Sarbanes-Oxley Act of 2002

.31 The Sarbanes-Oxley Act of 2002, signed into law on July 30, 2002, is the most significant legislation affecting the accounting profession since 1933. A discussion of the Sarbanes-Oxley Act of 2002 can be found in the general *Audit Risk Alert—2002/03* [AAM section 8010].

³ Readers should refer to the full text of the auditing standards and other pronouncements that are discussed in this section of the Alert. Readers should be alert for updates, amendments, or other changes to the rules discussed in this section of the Alert and other recent developments related to regulatory activities. The brief summaries provided in this section of the Alert are for informational purposes only. Readers should refer to the full text of the regulations and other documents that are discussed in this section of the Alert.

Fraud

.32 Recent highly publicized instances of fraudulent financial reporting serve as reminders to auditors of the need to remain alert to possible instances of fraudulent activity and to maintain an appropriate attitude of professional skepticism. Auditors should consider the guidance in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). SAS No. 99 supersedes SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316A); amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230); and amends SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333). SAS No. 99 does not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02).⁴ However, SAS No. 99 establishes standards and provides additional guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.

.33 SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.

.34 A more detailed discussion of SAS No. 99 can be found in the general *Audit Risk Alert—2002/03* [AAM section 8010]. Also, the AICPA has developed a Practice Aid, *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*. For more information about this Practice Aid, see the discussion "On the Bookshelf" in the "Resource Central" section of this Alert.

.35 The AICPA has launched a new, comprehensive Anti-Fraud and Corporate Responsibility Program. The program includes many initiatives, including the new auditing standard, SAS No. 99; the Institute for Fraud Studies; corporate training programs; and new continuing professional education (CPE) recommendations, among others. Information about the program, a list of initiatives, and other fraud resources are now available on the AICPA Web site at www.aicpa.org/antifraud/homepage.htm. Also, look for the AICPA's Anti-Fraud Resource Center, which will launch on the AICPA Web site, www.aicpa.org, and will offer comprehensive tools, resources, and information for fraud prevention, detection, and deterrence.

Auditing and Accounting for Investments

Significance to the Overall Audit

.36 An investment company's securities portfolio typically comprises substantially all its net assets. Accordingly, the audit of an investment company's investment accounts is a significant portion of the overall audit because of the relative significance of those accounts and of the related income accounts. In auditing the investment accounts, the auditor should consider various aspects of the investment company's transactions with brokers, custodians, and pricing services.

.37 Although the overall direction of the investment activities of an investment company is the responsibility of its board of directors, the board typically delegates the routine operating and investment decisions to an investment committee, a portfolio manager, or in most situations, an investment adviser. For some funds, the adviser may be assisted by one or more subadvisers.

⁴ 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). 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 (see SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 312]) or fraud

.38 The composition of an investment company's portfolio is primarily a function of the company's investment objectives and strategy to achieve them. For example, for some funds, the composition may reflect an investment objective that tracks the performance of a major index, such as the S&P 500 Index.

Guidance for Auditing Investments

.39 Auditors should consider the guidance in the Audit and Accounting Guide Audits of Investment Companies when auditing investment accounts. (See the related discussion "2002 Audit and Accounting Guide Audits of Investment Companies" in this section of the Alert, which discusses the update of the Guide with conforming changes.) Paragraphs 2.98 through 2.136 provide guidance on auditing procedures for investment accounts. Among the matters discussed are the principal objectives in auditing the investment accounts, consideration of internal control, and examination of transactions and detail records, including portfolio transactions with affiliates and valuation of investments.

.40 The auditing procedures in paragraph 2.101 in the Guide note that the auditor should review such relevant investment company documents as the latest prospectus, statement of additional information, certificate of incorporation, bylaws, and minutes of the board of directors' and shareholders' meetings to gain an understanding of the investment company's investment objectives and restrictions, and consider whether management has a program to prevent, deter, or detect noncompliance with the investment company's investment restrictions. The auditor should also consider whether the program has identified noncompliance with the stated investment restrictions and test the operation of the program to the extent considered necessary. An investment company's failure to comply with its stated investment restrictions may be considered a possible illegal act that may have an indirect effect on the financial statements of the fund. Should an auditor become aware of the possibility of an illegal act, the procedures delineated in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), should be applied. Auditors may also be required, under certain circumstances, pursuant to the Private Securities Litigation Reform Act of 1995 (codified in Section 10A(b)1 of the 1934 Act), to make a report to the SEC relating to an illegal act that has a material effect on the financial statements.

.41 Additional audit guidance for auditing investments is available in SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), and in the companion Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. Auditors should also consider the need for using the work of a specialist for valuation of complex financial instruments or restricted securities. SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), can be useful in providing guidance to auditors who use the work of a specialist in performing an audit in accordance with GAAS.

.42 Auditors should also consider the guidance in SEC Accounting Series Releases No. 113 and No. 118, as well as the SEC Division of Investment Management staff interpretive letters.⁵ This guidance may be useful to auditors and financial statement preparers in assessing investment valuations.

Accounting for Investments

.43 Accounting guidance for investments, including methods of valuing investments, defaulted debt securities, and expenditures in support of defaulted debt securities, lending of portfolio securities, and accounting for foreign investments, is discussed in paragraphs 2.19 through 2.97 of the Guide.

.44 Guidance on the valuation of investments is also provided in paragraph 1.32 in the Guide. Paragraph 1.32 states that values and changes in values of investments held by investment companies are as important

⁵ Letter from Douglas Scheidt, associate and chief counsel, SEC Division of Investment Management, to Craig S. Tyle, Investment Company Institute, December 8, 1999, and Letter from Douglas Scheidt, associate and chief counsel, SEC Division of Investment Management, to Craig S. Tyle, Investment Company Institute, April 30, 2001. You can obtain these documents on the SEC Web site at www.sec.gov.

to investors as the investment income earned. Investment companies, therefore, report investments at fair value. The fair value of an investment is the amount at which the investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The best evidence of fair value is the quoted market price in an active market. In the absence of a quoted market price, amounts representing estimates of fair values using methods applied consistently and determined in good faith by the board of directors should be used.

.45 As discussed in paragraph 2.133 of the Guide, auditors should determine whether their investment company clients have made appropriate disclosures about the method(s) and significant assumptions used to estimate the fair values of investments valued by their investment company clients using a valuation model. The auditor should become familiar with the SEC's FRRs on this subject, with an emphasis on Section 404.03 of the SEC's *Codification of Financial Reporting Policies*.

.46 See the related discussions "Accounting Standards Executive Committee Projects on Blockage and the Scope of the Audit and Accounting Guide *Audits of Investment Companies*" and "Exposure Draft on Auditing Fair Value Measurements and Disclosures" in the "On the Horizon" section of this Alert.

2002 Audit and Accounting Guide *Audits of Investment Companies*

.47 The Audit and Accounting Guide *Audits of Investment Companies* has been updated with conforming changes to reflect the issuance of authoritative pronouncements.

.48 Among the conforming changes to the 2002 edition of the Guide are updates for accounting pronouncements, including FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and FASB Statement No. 141, *Business Combinations*. Updates to the Guide for auditing and attestation pronouncements include conforming changes for SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*; SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319); Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT secs. 101–701); and Statement of Position (SOP) 01-4, *Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards*.

Money Laundering Developments

Money Laundering Activities

.49 Money laundering is the funneling of cash or other funds generated from illegal activities, often through legitimate financial institutions or 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 boundaries.

.50 Criminals use a wide variety of financial institutions and professional advisers to launder the proceeds of crime, and according to the U.S. Department of the Treasury, securities investment companies may also be vulnerable. The evolving dynamics of the industry—mergers and acquisitions, broader product lines, new technologies, and new distribution channels—generate important business opportunities, but they also generate risks for securities investment companies, including increased money laundering vulnerability.

.51 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 non-bank financial institutions make it more difficult for them to evade detection, the securities investment company industry may become increasingly vulnerable to money laundering and more attractive to money launderers.

Money Laundering and Financial Statements

.52 Money launderers tend to use the business entity more as a conduit than as a means of directly expropriating assets. For this reason, money laundering is far less likely to affect financial statements than are such types of fraud as misappropriations and consequently is unlikely to be detected in a financial statement audit. In addition, other forms of fraudulent activity usually result in the loss or disappearance of assets or revenue, whereas money laundering involves the manipulation of large quantities of illicit proceeds to distance them from their source quickly and in as undetectable a manner as possible. However, money-laundering activities may have indirect effects on an entity's financial statements.

.53 Nevertheless, independent auditors have a responsibility under SAS No. 54, *Illegal Acts by Clients*, to be aware of the possibility that illegal acts may have occurred, indirectly affecting amounts recorded in an entity's financial statements. In addition, if specific information comes to the auditor's attention indicating possible illegal acts that could have a material indirect effect (for example, the entity's contingent liability resulting from illegal acts committed as part of the money laundering process) on the entity's financial statements, the auditor must apply auditing procedures specifically designed to ascertain whether such activity has occurred.

.54 Money laundering is considered to be an illegal act that will often have an *indirect* effect on financial statement amounts under SAS No. 54. 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.

.55 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.

The Bank Secrecy Act

.56 The Bank Secrecy Act (BSA), enacted to address the problems of money laundering and other financial crime, 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 criminal and civil penalties. Investment companies are defined as financial institutions under the Act (Title 31 USC 5312 (a) (I)), and unless they are subsidiaries of bank holding companies, they are not currently required to report suspicious activity either by employees or by customers, to the Treasury Department. The Treasury Department encourages all bank and non-bank financial institutions to voluntarily report regarding suspicions of money laundering and related financial crime, as appropriate. 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.

The USA PATRIOT Act

.57 On October 26, 2001, President Bush signed into law the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001 (the Act). This law, enacted in response to the terrorist attacks of September 11, 2001, was intended to strengthen our nation's ability to combat terrorism and prevent and detect money laundering activities in all financial institutions. Broad authority to develop anti-money laundering regulations applicable to each of the various segments of the financial services industry was delegated to the U.S. Department of the Treasury. Title III of the USA PATRIOT Act amends the anti-money laundering provisions of the BSA.

Interim Final Rule on Anti-Money Laundering Programs for Mutual Funds

.58 In April 2002 the U.S. Department of the Treasury through the Financial Crimes Enforcement Network (FinCEN) issued an interim final rule to prescribe minimum standards applicable to mutual funds pursuant to the revised provision in the BSA that requires financial institutions to establish anti-money laundering programs. The application of the interim rule was limited to those investment companies falling within the category “open-end company” contained in Section 5(a)(1) of the 1940 Act, commonly referred to as “mutual funds.” Mutual funds are required by the interim final rule to develop and implement an anti-money laundering program reasonably designed to prevent the mutual fund from being used for money laundering or the financing of terrorist activities and to achieve and monitor compliance with applicable requirements of the BSA and the U.S. Department of the Treasury’s implementing regulations. Programs must be approved in writing by the mutual fund’s board of directors or trustees.

.59 In a separate interim rule, the U.S. Department of the Treasury temporarily exempted investment companies other than mutual funds from the BSA requirement that they establish anti-money laundering programs. The U.S. Department of the Treasury also temporarily deferred determining the definition of *investment company* for purposes of the BSA.

.60 Refer to interim final rules and the FinCEN Web site at www.fincen.gov for compliance date information.

Proposed Rule on Anti-Money Laundering Programs for Unregistered Investment Companies

.61 In a notice of proposed rulemaking, published in the September 26, 2002, *Federal Register*, the U.S. Department of the Treasury, through FinCEN, proposed amendments to the BSA regulations. The proposed rule would define an investment company to include certain investment vehicles not subject to regulation under the 1940 Act and require those entities to establish anti-money laundering programs. Hedge funds, private equity funds, venture capital funds, commodity pools, and real estate investment trusts would be covered by this proposed definition. Refer to the SEC and FinCEN Web sites for updated information about the proposed rule.

Proposed Rule on Customer Identification Programs for Mutual Funds

.62 In July 2002 the U.S. Department of the Treasury, through FinCEN, and the SEC jointly issued a proposed regulation (see Release No. IC-25657) to implement Section 326 of the USA PATRIOT Act. Section 326 requires the SEC and Secretary of the Treasury to jointly prescribe a regulation that, at a minimum, requires investment companies to adopt and implement reasonable procedures to (1) verify the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintain records of the information used to verify the person’s identity; and (3) determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to investment companies by any government agency. The scope of this proposed rule is limited to those entities required to register with the SEC as investment companies and that fall within the category of “open-end company” contained in Section 5(a)(1) of the 1940 Act, entities commonly referred to as mutual funds. The proposed rule would affect mutual funds that are small entities. Refer to the SEC and FinCEN Web sites for updated information about the proposed rule.

New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance

.63 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the writing of last year’s Alert. The AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] contains a summary explanation of all these issuances. For information on auditing and attestation standards

issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards Team and available at www.aicpa.org.

SAS No. 95	<i>Generally Accepted Auditing Standards</i> Issued in December 2001. This SAS is effective for audits of financial statements for periods beginning on or after December 15, 2001.
SAS No. 96	<i>Audit Documentation</i> Issued in January 2002. This SAS is effective for audits of financial statements for periods beginning on or after May 15, 2002. Early application is permitted.
SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i> Issued in June 2002. This SAS is effective for written reports issued or oral advice provided on or after June 30, 2002. Earlier application is permitted.
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i> Issued in September 2002. This SAS amends a number of SASs. The effective dates vary for the amendments.
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i> Issued in October 2002. This SAS is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.
SAS No. 100	<i>Interim Financial Information</i> Issued in November 2002. This SAS is effective for interim periods within fiscal years beginning after December 15, 2002. Early application of the provisions of the SAS is permitted.
SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i> Issued in May 2002. This SOP is effective upon issuance and is applicable only to agreed-upon procedures engagements that report on annual claims prompt payment reports as required by the New Jersey Administrative Code.
SSAE No. 11	<i>Attest Documentation</i> Issued in January 2002. This SSAE is effective for attest engagements when the subject matter or assertion is as of or for a period ending on or after December 15, 2002. Earlier application is permitted.
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i> Issued in September 2002. This SSAE is effective upon issuance.
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i> Issued September 2002. The new Guide is effective for audits of a state or local government's financial statements for the first fiscal period ending after June 15, 2003, in which the government does apply or is required to apply the provisions of Governmental Accounting Standards Board Statement No. 34, <i>Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments</i> , or GASB Statement No. 35, <i>Basic Financial Statements—and Management's Discussion and Analysis—for Public Colleges and Universities</i> .
Audit Guide	<i>Service Organizations: Applying SAS No. 70, as Amended</i> New edition as of April 15, 2002.

Audit Interpretations of SAS No. 70, <i>Service Organizations</i>	<p>Interpretation No. 4, "Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls"</p> <p>Interpretation No. 5, "Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods"</p> <p>Interpretation No. 6, "Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor's Engagement"⁶</p> <p>Published in the February 2002 <i>Journal of Accountancy</i>.</p> <p>Audit Interpretations are effective upon publication in the <i>Journal of Accountancy</i>.</p>
Audit Interpretation of SAS No. 73, <i>Using the Work of a Specialist</i>	<p>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. 140"</p> <p>Published in the December 2001 <i>Journal of Accountancy</i>.</p> <p>Audit Interpretations are effective upon publication in the <i>Journal of Accountancy</i>.</p>
Audit Interpretations of SAS No. 58, <i>Reports on Audited Financial Statements</i>	<p>Interpretation No. 14, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing"</p> <p>Published in the March 2002 <i>Journal of Accountancy</i>.</p> <p>Interpretation No. 15, "Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations"</p> <p>Published in the November 2002 <i>Journal of Accountancy</i>.</p> <p>Audit Interpretations are effective upon publication in the <i>Journal of Accountancy</i>.</p>
Audit Interpretation of SAS No. 1, section 420, <i>Consistency of Application of Generally Accepted Accounting Principles</i>	<p>Interpretation No. 12, "The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Change in the Year of Adoption"</p> <p>Published in the April 2002 <i>Journal of Accountancy</i>.</p> <p>Audit Interpretations are effective upon publication in the <i>Journal of Accountancy</i>.</p>
Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Practice Alert 02-1	<i>Communications with the Securities and Exchange Commission</i>
Practice Alert 02-2	<i>Use of Specialists</i>
Practice Alert 02-3	<i>Reauditing Financial Statements</i>
Statement on Quality Control Standards No. 6	<i>Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>
Practice Aid	<i>Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide</i>
Practice Aid	<i>New Standards, New Services: Implementing Attestation Standards</i>
Practice Aid	<i>Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users</i>

⁶ SAS No. 98, *Omnibus Statement on Auditing Standards—2002*, among other matters, amends SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324). The amendment revises the guidance in Interpretation No. 6, "Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor's Engagement" of SAS No. 70, *Service Organizations*, rescinds Interpretation No. 6, and brings the guidance from Interpretation No. 6 into SAS No. 70. This amendment is effective for reports issued on or after January 1, 2003.

.64 Of the pronouncements, guides, and other guidance listed above, those having particular significance to the investment companies industry are briefly explained below. These summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

Audit Guide Service Organizations: Applying SAS No. 70, as Amended

.65 The Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (new edition as of April 15, 2002) (product no. 012772kk) assists auditors in applying GAAS in audits of financial statements of entities that use service organizations, and in service auditors' engagements. Chapter 1 of this Audit Guide, "Audit Considerations for an Entity That Uses a Service Organization," identifies the information a user auditor may need about the processing performed by a service organization for a user organization, and also describes how a user auditor obtains that information. Paragraph 1.06 in this Guide provides examples of service organizations, including the following example regarding transfer agents, custodians, and recordkeepers for investment companies:

Transfer agents process purchases, sales, and other shareholder activity for investment companies. Shareholders or prospective shareholders of investment companies initiate transactions by contacting the transfer agent either in writing, by telephone through an automated response unit, or through the Internet. The transfer agent remits to (receives from) the investment company the net proceeds from the purchase and sale of shares in the investment company. The custodian is responsible for the receipt, delivery, and safekeeping of the company's portfolio securities; the receipt and disbursement of cash resulting from transactions in these securities; and the maintenance of records of the securities held for the investment company. The custodian may also perform other services for the investment company, such as collecting dividend and interest income and distributing that income to the investment company. Recordkeepers maintain the financial accounting records of the investment company based on information provided by the transfer agent and the custodian of the investment company's investments. From the perspective of the investment company, the transfer agent, custodian performing servicing, and recordkeeper may be service organizations. Accordingly, auditors of an investment company may obtain information from a service auditor's report on controls at a transfer agent, recordkeeper, and custodian. From the perspective of an investor, an investment company is not a service organization but rather an entity in which the investor has a financial interest; accordingly, SAS No. 70, as amended, does not apply.

.66 Other chapters in the Guide include discussions about the form and content of service auditors reports, and guidance to user auditors on using a service auditor's report on controls placed in operation (type 1 report) and a service auditor's report on controls placed in operation and tests of operating effectiveness (type 2 report), among other matters. Also, AU section 324: *Service Organizations*, is reproduced as Appendix F to this Audit Guide, and AU sec. 9324: *Service Organizations: Auditing Interpretations of Section 324* is reproduced in Appendix G to this Audit Guide. Appendix G includes the three new interpretations of SAS No. 70 previously listed in this section of the Alert.

New Accounting Pronouncements and Other Guidance

AICPA and FASB Pronouncements and Other Guidance

.67 Presented below is a list of accounting pronouncements and other guidance issued since the writing of last year's Alert. The AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] contains a summary explanation of all these issuances. These summaries are for informational purposes only and should not be

relied upon as a substitute for a complete reading of the applicable standard. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site, www.aicpa.org, and the FASB Web site, www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

- FASB Statement No. 145 *Rescission of FASB Statements No. 4, 44, 64, Amendment of FASB Statement No. 13, and Technical Corrections*
 Issued in April 2002. The provisions of this Statement related to the rescission of FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, shall be applied in fiscal years beginning after May 15, 2002, with early application encouraged. The provisions of paragraphs 8 and 9(c) of this Statement related to FASB Statement No. 13, *Accounting for Leases*, are effective for transactions occurring after May 15, 2002, with early application encouraged. All other provisions of this Statement are effective for financial statements issued on or after May 15, 2002, with early application encouraged.
- FASB Interpretation No. 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
 Issued in November 2002. The initial recognition and initial measurement provisions apply on a prospective basis to guarantees issued or modified after December 31, 2002, regardless of the guarantor's fiscal year end. The disclosure requirements in the Interpretation are effective for financial statements of interim or annual periods ending after December 15, 2002.
- FASB Statement No. 146 *Accounting for Costs Associated With Exit or Disposal Activities*
 Issued in June 2002. The provisions of this Statement are effective for exit or disposal activities initiated after December 31, 2002. Early application is encouraged.
- FASB Statement No. 147 *Acquisitions of Certain Financial Institutions*
 Issued in October 2002. See paragraph 7 of this Statement for effective date information.
- SOP 01-5 *Amendment to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*
 Issued in December 2001. This SOP is effective for annual financial statements for fiscal years ending on or after December 31, 2001, and complete sets of interim financial statements for periods beginning on or after that date and audits of those financial statements.
- SOP 01-6 *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*
 Issued in December 2001. Changes in accounting and financial reporting required by this SOP should be applied prospectively and are effective for annual and interim financial statements issued for fiscal years beginning after December 15, 2001, with certain exceptions. Early application is encouraged.
- Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*
 See the "New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance" section of this Alert for effective date information.
- Technical Practice Aids *Software Revenue Recognition*
- Questions and Answers *FASB Statement No. 87, Employers Accounting for Pensions*

Technical Practice Aids—Investment Companies⁷

Private Investment Companies Issue (Nonregistered)

.68 In January 2002, the AICPA Accounting Standards staff, helped by industry experts, released questions and answers (Q&As), commonly referred to as Technical Practice Aids (TPAs), on the implementation by private investment companies of certain provisions of the Audit and Accounting Guide *Audits of Investment Companies*. The TPAs relate primarily to the method of disclosing financial statement highlights by private investment companies and are as follows:

- *Clarification of Certain Terms When Reporting Financial Highlights by Non-Registered Investment Funds* (AICPA, *Technical Practice Aids*, vol. 1, sec. 6910.04)
- *Disclosure of Per Share or Per Unit Data When Reporting Financial Highlights by Non-Registered Investment Funds* (sec. 6910.05)
- *Reporting of Classes of Shares When Reporting Financial Highlights by Non-Registered Investment Funds* (sec. 6910.06)
- *Computation of Financial Ratios When Reporting Financial Highlights by Non-Registered Investment Funds* (sec. 6910.07)
- *Computation of Expense Ratio When Reporting Financial Highlights by Private Equity and Venture Funds* (sec. 6910.08)
- *Computation of Financial Ratios When Reporting Financial Highlights by Partnership Funds-of-Funds and Master-Feeder Funds* (sec. 6910.09)
- *Computation of Total Return When Reporting Financial Highlights by Non-Registered Investment Funds* (sec. 6910.10)

Reporting Financial Highlights by Separate Accounts

.69 In February 2002, the AICPA Accounting Standards staff, helped by industry experts, released Q&As, commonly referred to as TPAs, on reporting financial highlights by separate accounts. The TPAs provide guidance on how to apply the financial highlights requirement by the Audit and Accounting Guide *Audits of Investment Companies* to separate accounts and are as follows:

- *Reporting Financial Highlights by Separate Accounts* (AICPA, *Technical Practice Aids*, vol. 1, sec. 6910.11)
- *Reporting of Per Share or Per Unit Data When Reporting Financial Highlights by Separate Accounts* (sec. 6910.12)
- *Computation of Per Share or Per Unit Data When Reporting Financial Highlights by Separate Accounts* (sec. 6910.13)
- *Reporting Units Issued and Redeemed During the Period* (sec. 6910.14)
- *Transition* (sec. 6910.15)

Application of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*

.70 FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, among other matters, amends Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, to eliminate

⁷ "Technical Questions and Answers" specifically pertaining to investment companies are found in section 6910 of AICPA *Technical Practice Aids*. The questions and answers (Q&As) included in "Technical Questions and Answers" are nonauthoritative and are based on selected practice matters identified by the staff of the AICPA Technical Hotline and various other bodies within the AICPA. As of the writing of this Alert, the Q&As discussed in this section of the Alert are also available on the AICPA Web site at www.aicpa.org.

the exception to consolidation for a subsidiary for which control is likely to be temporary. At its November 7, 2001 meeting, the FASB clarified that the amendment is not intended to apply to the exception to consolidation for noninvestment company investees measured at fair value pursuant to paragraph 7.04 of the Audit and Accounting Guide *Audits of Investment Companies*. See FASB Action Alert No. 01-41.

Application of EITF Topic D-98, *Classification and Measurement of Redeemable Securities*

.71 Consistent with an SEC staff announcement published under Emerging Issues Task Force (EITF) Topic D-98, *Classification and Measurement of Redeemable Securities*, a registered investment company should not include preferred stock under the caption “Net assets” if the investment company may be required to redeem all or part of the preferred stock upon failure to satisfy statistical coverage requirements imposed by its governing documents or a rating agency, as discussed in paragraph 7.31 in the Audit and Accounting Guide *Audits of Investment Companies*.

.72 On July 12, 2002, the Chief Accountants Office of the Division of Investment Management released more guidance specific to the application of EITF Topic D-98 to closed-end funds. Of most significance, the staff indicated that distributions to preferred stockholders should be presented as a component of the net increase (decrease) in net assets resulting from investment operations, below net investment income on the statement of operations, the statement of changes in net assets and financial highlights. The staff indicated that preferred stock arrangements that are redeemable on a fixed or determinable date should follow the guidance set forth in EITF Topic D-98.

On the Horizon

.73 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] summarizes some of the more significant ongoing projects and exposure drafts outstanding. Presented below is brief information about certain ongoing projects and exposure drafts that are especially relevant to the investment companies industry. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.74 The following table lists the various standard-setting bodies’ Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed below and in the general *Audit Risk Alert—2002/03* [AAM section 8010]. Readers should refer to information provided by the various standard-setting bodies for further information.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board	www.fasb.org
Professional Ethics Executive Committee	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process the submission more efficiently. Include your full name, mailing address and, if available, your membership and subscriber number in the message.

Accounting Standards Executive Committee Projects on Blockage and the Scope of the Audit and Accounting Guide *Audits of Investment Companies*

.75 Chapter 1 in the Audit and Accounting Guide *Audits of Investment Companies* discusses the kinds of companies considered to be investment companies to which the provisions of the Guide apply. As noted in the Guide, the FASB expressed concerns regarding both the clarity of the scope of the Guide and the use of a blockage factor in estimating the fair value of certain unrestricted investments that have a quoted market price in an active market. As a result, the Accounting Standards Executive Committee (AcSEC) is undertaking two separate projects to address those concerns. For both issues, the Guide includes "standstill" provisions on current accounting practice as follows:

- *Clarification of the Scope of the Investment Companies Audit and Accounting Guide.* AcSEC plans to release in December 2002 an exposure draft of a proposed SOP, *Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*, to address this issue. Until that project is finalized, an entity should consistently follow its current accounting policies for determining whether the provisions of the Guide apply to investees of the entity or to subsidiaries that are controlled by the entity. Further, the FASB has expressed its view that an investment company (other than a separate account of an insurance company as defined in the 1940 Act) must be a separate legal entity to be within the scope of the Guide (see the FASB Action Alert No. 02-14, April 3, 2002). Accordingly, the specialized accounting principles in the Guide should be applied to an investment made after March 27, 2002, only if the investment is held by an investment company that is a separate legal entity. Investments acquired prior to March 28, 2002, or those acquired after March 27, 2002, pursuant to an irrevocable binding commitment that existed prior to March 28, 2002, should continue to be accounted for in accordance with the entity's existing policy for such investments. For further discussion of this matter, see the FASB Staff announcement in EITF Topic D-74, *Issues Concerning the Scope of the AICPA Audit Guide on Investment Companies*.
- *Use of a blockage factor.* If it was an entity's accounting policy in investment company financial statements issued for fiscal years ending on or before May 31, 2000, to apply a blockage factor to estimate the fair value of certain unrestricted investments that have a quoted market price in an active market, the entity may continue to apply that policy to those and similar investments. However, disclosure of the existence of such a policy is required. Otherwise, an entity may not elect to adopt such a policy pending the completion of AcSEC's project on this matter or FASB's project on measuring financial instruments at fair value.

FASB Exposure Draft on Consolidation of Certain Special Purpose Entities

.76 The FASB has issued an exposure draft of a proposed Interpretation, *Consolidation of Certain Special Purpose Entities*. This proposed Interpretation would address consolidation by business enterprises of special-purpose entities (SPEs) to which the usual condition for consolidation described in ARB No. 51, *Consolidated Financial Statements*, does not apply because the SPEs have no voting interests or otherwise are not subject to control through ownership of voting interest. The FASB expects to issue an interpretation in the fourth quarter of 2002. While it is still unclear how this exposure draft would affect investment companies, the impact could be significant.

Exposure Draft on Auditing Fair Value Measurements and Disclosures

.77 The AICPA's Auditing Standards Board (ASB) has released an exposure draft of a proposed SAS titled *Auditing Fair Value Measurements and Disclosures*. The proposed SAS addresses auditing considerations relating to measurement, presentation, and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in the financial statements. The ASB will discuss a revised draft of the proposed SAS at its December 2002 meeting. If approved at that meeting, the SAS is expected to be issued by February 2003.

New Framework for the Audit Process

.78 The AICPA's ASB has released an exposure draft of seven proposed SASs relating to the auditor's risk assessment process. See the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] for a discussion of these proposed SASs.

.79 You should keep abreast of the status of this project and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA Web site at www.aicpa.org.

Investment Companies Regulatory Liaison Task Force

.80 The AICPA established the Investment Companies Regulatory Liaison Task Force to liaise with regulatory agencies to advocate the profession's views and to provide technical counsel to ensure that related regulatory or broad private-sector requirements involving accounting, auditing, or work by CPAs for the investment companies industry are consistent with and workable under professional standards set in the private sector.

.81 Information on the task force and meeting highlights can be obtained at the AICPA Web site at www.aicpa.org.

Resource Central

Education courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

Checklist Supplement and Illustrative Financial Statements for Investment Companies

.82 The *Checklist Supplement and Illustrative Financial Statements for Investment Companies* (product no. 008943kk) is a nonauthoritative financial accounting and reporting practice aid for preparers or reviewers of financial statements of investment companies. This checklist should be used in conjunction with the *Checklists and Illustrative Financial Statements for Corporations* (product no. 008933kk).

Audit and Accounting Manual

.83 The *Audit and Accounting Manual* (product no. 005132kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditors' reports; checklists; and engagement letters, management representation letters, and confirmation letters.

Practice Aid, Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide

.84 In connection with the issuance of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, the AICPA has developed a new Practice Aid (product no. 006613kk). The Practice Aid includes topics such as:

- How the new SAS changes audit practice
- Developing an implementation plan
- Audit issues in revenue recognition
- Inquiries of entity personnel
- Practice aids, such as:
 - Specialized industry fraud factors, including the investment companies industry
 - Common frauds, and extended audit procedures

AICPA reSOURCE

.85 AICPA reSOURCE Online is an electronic library that provides instant access to the AICPA's *Professional Standards*, *Technical Practice Aids*, current Audit and Accounting Guides, current Audit Risk Alerts, and *Accounting Trends and Techniques*. To subscribe, go online at www.cpa2biz.com.

.86 The AICPA also has a CD-ROM product titled *reSOURCE: AICPA's Accounting and Auditing Literature*. This CD-ROM also enables subscription access to the AICPA Professional Literature products in a Windows format.

Education Courses

.87 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the investment companies industry, many of them available for both group study and self-study. For more information about AICPA CPE courses, call the AICPA (Member Satisfaction) at (888) 777-7077.

Online CPE

.88 The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee provides you with unlimited access to hundreds of courses of online CPE in one- and two-hour segments.

CPE CD-ROM

.89 *The Practitioner's Update* (product no. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

.90 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.91 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.92 Members of the AICPA Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Web Sites

AICPA Online and CPA2Biz

.93 AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, CPA2Biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the professional standards, and CPE courses.

Other Helpful Web Sites

.94 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the "Information Sources" table at the end of this Alert.

.95 This Audit Risk Alert replaces the *Investment Companies Industry Developments—2001/02* Audit Risk Alert. The *Investment Companies 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 appreciated. You may e-mail these comments to mkasica@aicpa.org or write to:

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Information Sources

<i>Organization</i>	<i>Web Site</i>
American Institute of Certified Public Accountants Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 Telephone: (888) 777-7077 (Member Satisfaction Center)	www.aicpa.org
Financial Accounting Standards Board <i>Order Department:</i> 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Telephone: (800) 748-0659	www.fasb.org
Financial Crimes Enforcement Network (FinCEN)	www.fincen.gov
U.S. Securities and Exchange Commission <i>SEC Headquarters:</i> 450 Fifth Street, NW Washington, DC 20549-0011 <i>Publications Unit:</i> Telephone: (202) 942-4040 <i>SEC Public Reference Room:</i> Telephone: (202) 942-8090 (202) 942-8092 (tty)	www.sec.gov
Investment Company Institute 1401 H Street NW Washington, DC 20005	www.ici.org

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AAM Section 8110

Securities Industry Developments—2002/03

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform the audits of your securities industry clients. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment your clients operate in. This Alert is an important tool in helping you identify the significant business risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the securities industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

Economic and Industry Developments

*What are the industry and economic conditions facing
broker-dealers and commodity entities in the current year?*

Weak Recovery and an Uncertain Future

.04 The economic word of the day for 2001 was “uncertain” and it still holds true for 2002. The current mix of opposing trends—solid demand, but no strong pickup in jobs—stems partly from the nature of this business cycle. In other words, mild recoveries tend to follow mild recessions. The U.S. economy stands stuck between a double-dip recession and a robust economic expansion.

.05 Growth in gross domestic product (GDP) soared in the first quarter of 2002 to an annual average of 5 percent but then fell back to an alarming growth rate of 1.3 percent. In the third quarter, GDP grew at a 3.1 percent annual rate, stimulated by increased car sales. Economists estimate that GDP will grow at a rate of less than 2 percent in the fourth quarter. The historical average for economic growth at this stage of the recovery is in excess of 5 percent.

.06 In November 2002, the Federal Reserve Board lowered the federal funds rate to 1.25 percent, its lowest level in 41 years. Corporate earnings reports through the first three quarters of 2002 were weak in many sectors. Consumer confidence also showed signs of weakening. Unemployment has barely changed since last year and it stood at 5.7 percent in October of 2002, significantly up from 3.9 percent two years earlier. Economists believe that the economy needs to start growing at a faster rate before unemployment can decline.

Stock Market Woes

.07 Through the first three quarters of 2002, the downward slide of the Dow Jones Industrial Average (DJIA), the National Association of Securities Dealers Automated Quotation (NASDAQ) Composite Index, and the Standard & Poor's 500 stock index (S&P 500) that began in 2000 continued. The volatility in the stock

markets, concerns over possible military action in Iraq, corporate scandals, and fears that the recovery will not last have sapped investor confidence, prompting investors to reconsider their investment strategies. In July 2002, for the first time in 15 years, investors pulled more money out of stock mutual funds than they put in during the preceding year. This negative trend continued for the rest of the summer. Throughout the year analysts were evaluating economic conditions and drastic declines in stock market indexes—comparing them to prior periods and trying to decide if we had finally reached rock bottom. But the stock market kept surprising us all by further declining and sending various indexes to their record lows. On October 9, 2002, the DJIA finished at 7286.27, its lowest close in nearly five years; the NASDAQ ended at 1114.11, its lowest level in more than six years; while the S&P 500 fell to 776.76, its lowest finish in more than five years. All of these indicators are significantly below the panic levels following the events of September 11, which investors thought were the lowest they would ever see. The stock market began an upward climb during the fall, resulting in a 10.6 percent gain in the DJIA in the month of October, its strongest monthly gain since 1987.

.08 The currency markets, too, have experienced nail-biting dips. Like stocks, the dollar was hit hard by the forecasts of weak growth. The dollar went into a nosedive against the euro, sinking 18 percent from mid-January to mid-July 2002. In the third quarter of 2002, however, the dollar rebounded and strengthened.

.09 The year 2002 was another bad one for the securities industry. With a declining stock market and business dwindling in such profitable areas as stock and bond underwriting and mergers and acquisitions, investment bank earnings for the first three quarters of 2002 were significantly lower than last year. The economists do not foresee a turnaround until at least 2003. And even then nobody expects the activity levels to reach those of the late 1990s.

Aftermath of September 11

.10 More than a year after the terrorist attacks of September 11, 2001, the financial industry is still dealing with the consequences. Out of 2,820 people dead or missing in New York City, more than 40 percent worked in the financial services sector. The industry that relies heavily on personal relationships lost a number of professionals who have been hard to replace. Some of the affected firms, in an attempt to restore some normalcy to their operations, rushed to fill vacancies. In a number of cases, people were elevated to high ranks without proper managerial experience. As an auditor of a securities firm that had to replace a significant portion of its staff, you need to consider the effect of new personnel on your client's internal control system. Statement on Auditing Standards (SAS) No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, 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).

.11 In the year since September 11 a number of securities firms left downtown Manhattan and moved their offices elsewhere. For some companies the move was necessary because their facilities were damaged or destroyed by the attacks. Others realized the need to disperse their operations to ensure business continuity in case of another disaster. One of the lessons learned after September 11 was the inappropriateness of concentrating people and operations in a small geographic area. The New York Stock Exchange (NYSE) soon will be divided into two separate locations—the existing one on Wall Street and another one somewhere within New York State. As you prepare to conduct audits of firms that relocated some or all of their operations, you must gain an understanding of this new environment in order to adequately plan and perform the audit.

Business Continuity Addressed by Regulators

.12 The issue of business continuity was also addressed by various regulatory agencies this year. In August 2002, the Securities and Exchange Commission (SEC) together with the Federal Reserve and the Treasury Department (the agencies) issued for comment a *Draft Interagency White Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System*. After consideration of the comments received, the agencies

intend to issue a final version of the white paper and to incorporate these sound practices into supervisory expectations or other forms of guidance. This white paper discusses business continuity objectives that have special importance after September 11 and their scope of application; the agencies' preliminary conclusions with respect to key factors affecting the resilience of critical markets and activities in the U.S. financial system; sound practices to strengthen financial system resilience; and an appropriate timetable for implementing these sound practices. Under the new plan, if adopted, securities firms might have to move their backup facilities as far as 200 or 300 miles away from their primary sites. The plan also states that the firms need to have sufficient trained staff located at or near the backup site to resume critical operations within a few hours of a disaster. The sound practices apply most directly to "core clearing and settlement organizations" and "financial institutions that play significant roles in critical markets." Critical markets are defined as the markets for federal funds, foreign exchange, commercial paper, and government, corporate, and mortgage-backed securities. The critics of the plan say that the cost of setting up and staffing remote backup facilities would be too high for some firms to handle. Comments on the draft white paper were due by October 21, 2002.

.13 Also in August, the NASD and the NYSE filed with the SEC proposed rule changes relating to business continuity plans. The proposed rule changes will require members to develop and maintain business continuity plans that establish procedures to be followed in the event of an emergency or significant business disruption. Members will be required to make such plans available to the NASD and/or NYSE (whichever organization is their designated examining authority with respect to financial and operational issues) upon request. Members will also be required to conduct an annual review of their business continuity and contingency plans to determine whether any modifications are necessary in light of changes to the member's operations, structure, business, or location.

.14 Recently the Securities Industry Association (SIA) published its *Best Practices Guidelines for Business Continuity*. According to the SIA, the best practices outline what securities firms should include in their own efforts to ensure that, in the event of an emergency, they can either continue operating or reestablish operations with minimal disruption to their business.

Compliance System

.15 Recent high-profile broker fraud cases put a spotlight on Wall Street firms' compliance practices. The general purpose of a compliance function within a securities firm is to review the activities of the sales departments and branch office operations. A recent case deserves some special attention. For 15 years a star broker, who recently pleaded guilty to a number of charges including misusing more than \$50 million of investors' money, was making unauthorized transfers from customer accounts. To cover up his activities, he diverted clients' brokerage-account statements to post office boxes he controlled or third-party addresses and then sent his clients forged statements inflating the value of their holdings. What is special about this case is that the two securities firms where this broker was employed during this 15-year period did not discover his fraudulent activities until January 2002, when the perpetrator himself sent a letter to the Federal Bureau of Investigation describing in detail how he was able to execute his scam for so long. This case underscores a number of fundamental problems with the way some Wall Street firms monitor their brokers, especially top-producing ones.

.16 One of the reasons why that broker's activities were never discovered by the compliance departments in both firms is that this broker, who was a branch manager, helped supervise the top compliance executive in his office. Experts say that despite the apparent conflict of interest, it is a common practice in the securities industry for compliance personnel to be subordinate to and report to branch managers whose activities they are supposed to be policing. Some firms responded to this incident by prohibiting their branch managers from being active brokers and requiring them to focus more on supervising brokers in their offices.

.17 Another issue raised by this case is the hesitancy on the part of some securities firms to supervise their top-producing brokers. Compliance officials are afraid that these high performers may find any scrutiny

to be offensive and leave, taking their clients and the significant assets they control along with them. There were a number of red flags in the case described above which should have tipped off compliance personnel that something was going on. Industry experts say one of the circumstances that should have been questioned was the disproportionate amount of commissions the broker appeared to have earned from his clients' asset base. In 1999 the broker generated almost \$6 million of commissions on client assets of just slightly over \$100 million while the industry average for commissions that year was below \$500,000.

.18 Another issue that should have been addressed by compliance officials was the presence of the broker's personal computer on his desk despite the fact that it was against the firm's policy. Investigators allege that the broker used his personal computer to falsify client account statements. Mailing customer statements and confirmations to a post office box is a fundamental concern of any basic compliance program. Industry experts also question whether the broker's activities could have been discovered earlier had his employers called his customers to check on his performance. Instead of making phone calls, some companies prefer to send out letters to customers along with account statements to verify that the firm's information matches the clients' records. Securities firms routinely use such spot-checks as part of their compliance procedures. It is unclear if either of the securities firms ever called any of the broker's clients, but some of the clients claim they never received such calls.

.19 After this case came to light, Wall Street's compliance became the center of attention of a congressional hearing. The SEC, NYSE, and the regulatory arm of the National Association of Securities Dealers (NASD) launched a joint "examination" of compliance practices in the securities industry. Recently, the NYSE proposed new rules to strengthen the internal controls at the branch offices of securities firms. The NASD is expected to come up with a similar proposal.

.20 The aforementioned case highlighted a number of weaknesses in the compliance and internal control systems of some securities firms. As an auditor of a broker or dealer in securities (broker-dealer), you are required by the SEC to issue a report on your client's internal control describing any material inadequacies found to exist or to have existed since the date of the previous audit. Refer to SEC Rule 17a-5 and SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), for more guidance on reports on internal control. Also be aware that failure on the part of securities firms to supervise their employees opens them up to significant legal exposure. As an auditor of a securities firm, you need to consider the impact of litigation on your client's financial statements. See the "Litigation, Claims, and Assessments" section of this Alert for a further discussion of this topic. For a discussion of auditor's responsibility with respect to fraud, see the "Fraudulent Financial Reporting" section of this Alert.

Research Analysts

.21 Research analysts attracted a lot of attention in 2002. Analysts were questioned by Congress about their failure to foresee the collapse of Enron despite the presence of numerous red flags. According to the data released by the Senate Governmental Affairs Committee, 10 out of 15 analysts following Enron were still promoting the stock to their clients weeks after the SEC started probing Enron's financial condition.

Numerous Investigations Into Conflicts of Interest

.22 The New York attorney general inquired into a major securities firm's research practices, generating more bad publicity for the securities industry. The attorney general alleged that the securities firm's research analysts issued bullish recommendations on certain Internet stocks while privately criticizing the same stocks. He argued that the firm's analysts were not independent and their ratings were influenced by the desire of their employer to win investment-banking business. To settle the case, the securities firm agreed to pay a \$100 million penalty and agreed to a number of changes to separate research from investment banking and to enhance disclosures in its research reports of multiple relationships with stock issuers.

.23 Having won a settlement in that case, the attorney general turned his attention to the research practices of other major securities firms. The latest focus of his investigation is on the work of a former star telecom analyst and his former firm. Among other things, the attorney general is investigating the telecom analyst's dual role of helping his former employer win investment-banking business from top telecom companies while also actively promoting stocks of those companies to individual investors in his research reports. Recently the attorney general expanded his probe to determine if the telecom analyst's superiors had any influence on his stock recommendations, indicating company-wide conflicts of interest.

.24 Moreover, the NASD charged the telecom analyst and his former employer with improper action connected to his research on a communications company. The regulators allege that the analyst misled investors by maintaining a bullish recommendation on the company, an investment-banking client of his employer, up until a couple of days before the communications company filed for bankruptcy, despite numerous factors pointing to the company's deteriorating condition.

.25 Having spent months dealing with allegations of conflicts of interest involving overly optimistic research analysts, industry regulators had to switch gears and investigate an analyst accused of going too far in trying to obtain information for his research report. In October 2002, the NASD imposed sanctions on a health-care analyst for trying to enroll into a clinical drug trial to find out about the drug's side effects and the progress of the trial. Based on the information the analyst was able to obtain, he published a research report telling his clients to sell the stock, thus causing a significant decline in the stock price. As it turned out, his report was inaccurate. The securities firm where the analyst had worked was also sanctioned for having inadequate training and written supervisory procedures for its research department.

Regulators Take Action on Conflicts of Interest

.26 In April 2002, the SEC commenced a formal inquiry into market practices concerning research analysts and the potential conflicts that can arise from the relationship between research and investment banking. The inquiry will be conducted jointly with the NYSE, the NASD, the New York attorney general, the North American Securities Administrators Association (NASAA), and the state regulators. The inquiry will help determine the necessity of additional rulemaking and whether any laws have been violated.

.27 In May, the SEC approved proposed changes to the rules of the NASD and the NYSE to address conflicts of interest that are raised when research analysts recommend securities in public communications. See the "Self-Regulatory Organization Regulations" section of this Alert for more information on the new rules. Also, the NYSE board of directors recently approved additional proposed rule changes requiring "further separation of analysts from investment banking activities."

.28 In August, the SEC proposed a rule entitled *Regulation Analyst Certification*. The proposed regulation would require that any research report disseminated by broker or dealer include certifications by the research analyst that the views expressed in the research report accurately reflect the analyst's personal views, and state whether the analyst received compensation or other payments in connection with his or her specific recommendations or views. A research analyst would also be required to provide certifications and disclosures in connection with public appearances.

.29 In October 2002, the SEC, the New York State Attorney General's Office, the NYSE, the NASD, and the NASAA announced a joint effort to bring to a speedy and coordinated conclusion the various investigations concerning analyst research and initial public offering (IPO) allocations. (See the "Initial Public Offering Practices" section below for more information on the issue of IPO allocations.) The participating regulatory entities will attempt to formulate a common plan to address conflict-of-interest and other issues pertaining to research analysts and IPO allocations. This plan will then be used as a template to structure appropriate settlements with the companies that are currently under investigation and to provide a sound basis for proposing industry-wide rules and regulations (including structural reforms) that will be used to govern in these areas.

.30 Analyst conflicts of interest were also addressed in the landmark Sarbanes-Oxley Act of 2002. Section 501 of the new law requires the SEC, or industry regulators with the authorization and direction of the SEC, to adopt rules designed to address conflicts of interest in order to improve the objectivity of research and provide investors with more useful and reliable information and rules requiring disclosures of conflicts of interest.

Possible Litigation

.31 In addition to being the focus of attention of various regulatory agencies concerning their research practices, brokerage firms face a number of class action suits and individual arbitration claims filed against them citing recommendations of their analysts. Legal experts believe that the activities of federal and state regulators regarding research analysts will benefit individual investors and make it easier for them to recover money lost on technology stocks from the securities firms. Legal proceedings are hurting investment banks' profitability by forcing them to pay significant amounts of money in legal fees and settlements. As an auditor of a securities firm, you need to consider the impact of litigation on your client's financial statements. See the "Litigation, Claims, and Assessments" section of this Alert for a further discussion of this topic.

Initial Public Offering Practices

.32 Wall Street's IPO practices were another area that was heavily scrutinized by regulators in 2002. In January, following a 10-month investigation, the NASD and the SEC fined a major firm \$100 million for extracting tens of millions of dollars from customers in inflated commissions that amounted to a "profit sharing" arrangement for allocations of "hot" IPOs, according to the NASD. During the tech boom, when IPOs almost always increased in value right after they started trading and, as a result, were hard to get, the firm allocated IPO stocks to customers who agreed to share their IPO profits with the firm in the form of excessive commissions on transactions unrelated to the IPO. The NASD found that such quid pro quo agreements violated a number of its rules, including the rules prohibiting brokers from sharing in the profits of client accounts and requiring brokerage firms to adhere to just and equitable principles of trade.

.33 The New York attorney general, Congress, and the NASD are investigating another major firm's IPO practices. Based on the evidence available so far, it appears that during the telecom boom this firm allocated numerous shares of hot IPOs to personal brokerage accounts of telecom executives at below-market prices. If investigators determine this was done in the hopes of winning investment-banking business from the executives' companies, this practice, known as "spinning," can be found to be in violation of the NASD's Free-Riding Rule. According to the NASD, the purpose of the Free-Riding Rule is to protect the integrity of the public offering system by ensuring that shares are sold to the general public and that broker-dealers do not withhold the securities for their own benefit or use them to reward persons who are in a position to direct future business to the broker-dealer.

.34 Securities firms were also accused of inducing investors who wanted IPO shares to purchase additional shares of the same stocks in the aftermarket in an attempt to drive up prices of those shares, a practice known as "laddering."

.35 There were several lawsuits filed against brokerage firms charging that the firms profited illegally from IPOs by intentionally underpricing the shares in hopes of later on sharing profits generated by the stocks with clients who received the coveted IPO shares.

New Regulatory Actions

.36 To address these alleged improprieties, in July the NASD proposed a set of new rules governing allocation of IPOs that would ban such practices as spinning, laddering, and quid pro quo agreements. These proposed rules have been released for public comment and will require SEC approval. In October, the NASD and the NYSE named the IPO Advisory Committee to review the IPO process. Based on the findings of the Committee, the two self-regulatory organizations intend to make rule proposals and other recommendations

to the SEC. Also in October, the SEC along with other industry regulators announced a joint effort to bring to a fast conclusion the various investigations concerning analyst research and IPO allocations. (See the previous section “Research Analysts” for more information on this initiative.)

.37 Regulatory actions and litigations discussed above may have significant adverse financial consequences for a broker-dealer as well as damage the firm’s reputation and growth prospects. In the worst-case scenario, noncompliance with regulations may even lead to the suspension or revocation of a broker-dealer’s registration. As an auditor of a securities firm, you need to consider the impact of litigation and new regulation on your client’s financial statements. See the “Litigation, Claims, and Assessments” section of this Alert for a further discussion of this topic.

Enron

.38 Enron Corp.’s collapse in 2001 turned out to be much more than the second largest bankruptcy in U.S. history. This scandal brought to light numerous conflicts of interest inherent in the business model of major Wall Street firms. Securities firms served in many conflicting capacities in their dealings with Enron. They acted as lenders, advisers, and underwriters for Enron while also managing assets for the energy company, its executives, and investors. Investigators in the Enron case recently switched their attention from accountants to financial institutions and the role they played in the rise and fall of the company. Congress, the SEC, and the Justice Department are questioning three of the largest U.S. financial firms about financing they provided to Enron. The investigators are examining whether the firms helped Enron artificially increase its earnings by structuring transactions in a way that allowed the energy concern to disguise loans as trades and hide debts in special-purpose entities.

.39 In addition to the investigations, Wall Street firms that did business with Enron face lawsuits filed by the company’s shareholders and employees accusing them of participating in a scheme with the energy company to defraud shareholders and creditors. There were also several lawsuits filed alleging that broker-dealers promoted Enron securities to the public even when as lenders they were or should have been aware of the true state of the company’s finances and that it was about to collapse.

More Regulatory Action Coming

.40 To boost investor confidence in the U.S. financial system following the collapse of Enron, the board of directors of the NASDAQ Stock Market, Inc. in July 2002 approved more than 25 new corporate governance reform proposals designed to increase accountability and transparency for the benefit of investors. Pending approval by the NASD board, they will be forwarded to the SEC for final approval. Shortly thereafter, on August 1, the NYSE board of directors ratified a sweeping set of proposals for its listed companies with respect to corporate governance. These proposals focus on giving boards greater independence and investors greater say in the governance of their companies. The American Stock Exchange (AMEX) board of governors formally approved enhanced rules that will increase disclosure requirements, strengthen board oversight and audit committee responsibility, and provide for increased shareholder rights for its listed companies. The measures will be presented to the SEC for review and approval.

.41 Legislators are considering the need for more regulation. Section 705 of the Sarbanes-Oxley Act of 2002 requires the Comptroller General to conduct a study on whether investment banks and financial advisers assisted public companies in manipulating their earnings and obfuscating their true financial condition. Among other things, the study will address the role financial institutions played in the collapse of Enron. Upon the completion of the study, the Comptroller General will issue a report discussing regulatory or legislative steps that are recommended or that may be necessary to address concerns identified in the study.

.42 Broker-dealers operate in a highly regulated industry that requires close attention to compliance matters. As an auditor of a broker-dealer, you need to stay alert to regulatory and legislative developments to ensure your client’s compliance with the regulations.

Stock Options

.43 As the rash of accounting scandals has put the spotlight on companies' financial statements, the accounting treatment of stock options has also come under scrutiny. Until now, just a few companies elected to account for stock options by using the fair value based method defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, which requires companies to recognize an expense for the fair value of the options granted in arriving at reported earnings. Most companies used the intrinsic value based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, which requires companies to recognize compensation cost based on the difference, if any, between the quoted market price of the stock and the amount an employee must pay to acquire the stock. Most fixed stock option plans have no intrinsic value at grant date, and under APB Opinion No. 25 no compensation cost is recognized for them. Throughout 2002, a number of major U.S. companies from various industries announced their intentions to change their accounting policies for stock options and to begin expensing them as early as 2003. In August 2002, the members of the Financial Services Forum, a group of top executives from 21 of the largest U.S. financial firms, decided to join these companies. At this point, most of the major securities firms have announced their decision to start expensing stock options.

.44 The FASB decided to undertake a limited scope project to reconsider the transition and disclosure provisions of FASB Statement No. 123 to provide guidance to companies that are voluntarily adopting a fair value based method. In October 2002 the FASB issued an exposure draft of a proposed Statement, *Accounting for Stock-Based Compensation—Transition and Disclosure*, that would amend FASB Statement No. 123. The proposed Statement *would not* require companies to adopt the fair value recognition provisions of FASB Statement No. 123. It would provide optional transition methods for those companies that decide to voluntarily adopt the fair value recognition principles of Statement No. 123 and would modify the disclosure requirements of that Statement. The final Statement is expected to be issued by the end of 2002.

.45 The international community is addressing the stock-based compensation issue as well. The International Accounting Standards Board (IASB) concluded its deliberations on the accounting for share-based payments, including employee stock options. It announced plans to issue a proposal for public comment in the fourth quarter of 2002. The proposal would require companies using IASB standards to recognize, beginning in 2004, the fair value of employee stock options granted as an expense in arriving at reported earnings. While there are some important differences between the methodologies in the IASB proposal and those contained in the proposed amendment to FASB Statement No. 123, the fundamental approach is the same—fair value measurement of employee stock options granted with expense recognition over the vesting period of the options.

.46 The debate to expense or not to expense stock options continues. As an auditor of a securities firm which uses stock options as a method of compensation, you need to stay on top of these developments. See the "Expensing Stock Options" section of the general *Audit Risk Alert—2002/03* [AAM section 8010] for more information.

Layoffs

.47 To compensate for the drastic slowdown in merger-and-acquisition (M&A) activity and IPOs—traditionally the biggest sources of revenue for the securities industry—Wall Street firms had to find ways to cut costs to sustain their profitability. Big payrolls, which represent the largest expense for the securities industry, were a number one target. During 2001 securities firms made major cuts which affected mostly lower-level employees. In 2002 the firms were forced to let go some of their higher ranks. According to the SIA, securities firms have eliminated a total of 32,287 jobs, or 8.8 percent of their work force, since the end of 2000. An effort on the part of the regulators to separate research from investment banking is likely to lead to further reductions in staffing levels.

.48 As an auditor of a securities firm that went through layoffs, you need to consider the effects of layoffs on your client's internal control as well as ensure that employee-related termination charges were properly

accounted for. Depending upon the breadth and the handling of the layoffs, key people and key controls may be missing and a firm's employees may be significantly demoralized; as such the foundation of financial reporting may be compromised. Auditors will need to be alert and use common sense to discern the quality of the firm's operational practices and environment and the impact upon the reliability of the firm's financial records. See "Employee Layoffs" in the "Audit and Accounting Issues and Developments" section of this Alert for a detailed discussion of this topic.

Increased Competition

.49 The securities industry was hurt in 2002 by a dramatic slowdown in the IPO market and M&A activity. In the third quarter, there were only seven IPOs by U.S. companies, the lowest number since the first quarter of 1980. The volume of U.S. equity and equity-linked securities issuance declined by 43 percent in the same quarter. The value of U.S. merger deals also fell 42 percent from the third quarter of 2001 to the same period in 2002. With so few deals up for grabs the securities firms compete fiercely for business.

.50 In addition to that, broker-dealers are facing increased competition from commercial banks. The biggest threat comes from megabanks which hope to lure customers away from traditional brokerages and investment banks by offering all kinds of financial services under one roof. To compete, investment banks are offering various types of financing to their clients, including credit lines, hoping the clients will not walk away and take the investment banking deals with them. In some cases, your broker-dealer clients may resort to unethical practices to retain and attract clients, such as providing loans in exchange for lucrative investment-banking business. In September 2002 the NASD advised its members that "the practice of tying commercial loans to investment-banking business violates federal statutes and NASD's rule requiring its members to adhere to just and equitable principles of trade."¹ It is important for broker-dealers to comply with regulatory requirements since noncompliance may result in fines or even the suspension or revocation of the broker-dealer's registration. See the "Pressure on Management to Perform" section of this Alert for a discussion of some additional issues auditors should be concerned with when auditing a client operating in a highly competitive environment.

Going-Concern Issues

.51 According to the SIA, it looks like the securities industry's profits for 2002 will hit the lowest level in seven or eight years. The continuous stock market decline and the mounting pressures from regulators are putting the securities industry to the test. Amid the multiple investigations into research and IPO practices of Wall Street firms and the poor economic outlook, ratings agencies warned they may lower the credit ratings of several major securities firms. If this happens, it will significantly raise the costs of conducting operations by making debt financing more expensive and less available as well as forcing the firms to pledge higher collateral to conduct their derivatives trading. Although larger firms may be able to absorb the higher cost, some smaller and medium-sized firms may not, thus raising possible going-concern issues.

.52 A recent study conducted by Weiss Ratings Inc. indicated a weakness in auditors' ability to spot and disclose potential bankruptcies. Auditors issued unqualified opinions for nearly half the public companies that filed for bankruptcy during the 18-month period ending June 30, 2002. If an auditor fails to raise the issue of going-concern for a client that files for bankruptcy within a year from the date of the audit, the auditor is most likely to face litigation from his or her client's creditors and investors. Creditors in bankruptcy and bankruptcy trustees pursue all viable sources of recovery and often view a civil claim against an insured third-party professional service provider (auditors) as the only reliable source of recovery when there are no significant assets to be liquidated. With that in mind you should be especially careful when evaluating your client's ability to continue as a going concern for another year. See "Going-Concern Issues" in the "Audit and Accounting Issues and Developments" section of this Alert for guidance on evaluating whether there is substantial doubt about a client's ability to continue as a going concern.

¹ National Association of Securities Dealers (NASD) News Release, *NASD Advises Securities Firms on Tying Arrangements*, September 19, 2002.

Money Laundering

.53 After the events of September 11, government officials have been increasingly concerned about the vulnerability of the securities industry to money laundering activities. On October 26, 2001, President Bush signed into law the “Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot) Act of 2001.” This law was intended to strengthen our nation’s ability to combat terrorism and prevent and detect money laundering activities in all financial institutions. Broad authority to develop anti-money laundering regulations applicable to each of the various segments of the financial services industry was delegated to the Treasury Department (Treasury). “Money Laundering Activities” in the “Audit and Accounting Issues and Developments” section of this Alert provides an explanation of what money laundering is and how it can affect your client as well as your audit. It also discusses new anti-money laundering rules that were issued this year by the Treasury along with the SEC, CFTC, and other regulatory agencies.

The Commodities Industry

.54 The Commodity Futures Trading Commission (CFTC or Commission) is an independent federal agency responsible for regulating commodity futures and options markets in the United States. The mission of the CFTC is to protect market users and the public from fraud, manipulation, and abusive practices related to the sale of commodity futures and options and to foster open, competitive, and financially sound commodity futures and option markets. As part of this process, brokers and individuals who handle customer funds or give trading advice must apply for registration through the National Futures Association (NFA), a self-regulatory organization approved by the Commission as a registered futures association.

.55 Commodity exchanges complement federal regulation with rules of their own—rules covering clearance of trades, trade orders and records, position limits, price limits, disciplinary actions, floor trading practices, and standards of business conduct. The CFTC also regularly reviews NFA’s and each exchange’s programs for ensuring member compliance with financial and other rules.

Futures and Options Business Doing Well

.56 Judging by the first eight months of 2002, futures and options exchanges are on their way to another record year in terms of global trading volume. More than 3.8 billion listed derivatives contracts changed hands worldwide from January through August, an increase of 42.6 percent over the same period in 2001. Should this upward trend continue for the remainder of the year, it bodes well for futures commission merchants (FCMs), because the volume of futures and options contracts traded bears directly on their revenues.

.57 In general, trading activity was driven by continued uncertainty about interest rates and exceptionally high volatility in equity markets, as well as a shift in the energy markets from over-the-counter (OTC) markets to exchanges. Equity index products showed very strong growth in all regions.

.58 In August 2002, the SEC and the CFTC approved final rules for trading single-stock futures. Futures exchanges hope that this will lead to an increase in business. As a possible harbinger of that happening, single-stock futures trading on foreign exchanges soared 180 percent higher in the first eight months of 2002 over the comparable 2001 period.

.59 Although most major commodities exchanges have in place the mechanisms needed to convert from membership-owned organizations to for-profit public companies, at the time of writing this Alert, none have offered shares to the public. It should be noted that the major stock exchanges have deferred their planned offerings as well.

.60 Traditional open outcry trading on commodity exchange floors continues to be challenged by electronic trading platforms. It remains to be seen how these developments will affect the value of exchange memberships and customers served by those exchanges.

Regulatory Issues and Developments²

What are some of the recent regulatory developments affecting broker-dealers?

.61 Chapter 5, "Auditing Considerations," of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* discusses auditing considerations for an audit of the financial statements of a broker-dealer. The Guide notes that the regulatory environment of a broker-dealer has a major effect on the audit of a broker-dealer because of the requirements that auditors report on the adequacy of the broker-dealer's internal control and on its compliance with the specific rules addressing financial responsibility and recordkeeping. Accordingly, certain tests of controls are performed even if the auditor might not otherwise do so.

.62 The audit and reporting requirements for securities broker-dealers are regulated by Rule 17a-5 under the Securities Exchange Act of 1934 (Exchange Act). An alternative regulatory framework has been created for OTC derivatives dealers that establishes a special class of broker-dealers who may choose to register with the SEC under a limited regulatory structure. 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.

.63 Qualifications and reports of independent accountants of commodity entities are specified by Regulation 1.16 of the Commodity Exchange Act (CEA).

.64 Before undertaking the audit of a regulated entity, auditors should read the applicable rules and understand the prescribed scope of the audit and the related reporting requirements.

SEC Regulations

What are some of the final rules issued during the past year by the SEC that may affect broker-dealers?

.65 The following is a summary of some of the rules that the SEC issued during 2002.

- *Applicability of CFTC and SEC Customer Protection, Recordkeeping, Reporting, and Bankruptcy Rules and the Securities Investor Protection Act of 1970 to Accounts Holding Security Futures Products.* See the "Commodity Futures Trading Commission Regulations" section of this Alert for a detailed discussion of this regulation.
- *Confirmation Requirements for Transactions of Security Futures Products Effected in Futures Accounts.* In September 2002, in accordance with the Commodity Futures Modernization Act (CFMA), the SEC adopted rule amendments and a new rule under the Exchange Act which are designed to clarify the disclosures broker-dealers effecting transactions in security futures products in futures accounts must make in the confirmations sent to customers regarding those transactions. The amendments provide that broker-dealers effecting transactions in security futures products in futures accounts do not have to disclose all of the information required by the SEC's confirmation disclosure rule, but rather require

² Readers should be alert for updates, amendments, or other changes to the rules discussed in this section of the Audit Risk Alert and other recent developments related to regulatory activities. The brief summaries provided in this section of the Alert are for informational purposes only. Readers should refer to the full text of the regulations. The complete text of Securities and Exchange Commission (SEC) final rules, including rules adopted subsequent to the writing of this Alert, can be obtained from the SEC Web site at www.sec.gov. The complete text of Commodity Futures Trading Commission (CFTC) final rules, including rules adopted subsequent to the writing of this Alert, can be obtained from the CFTC Web site at www.cftc.gov. See the "Information Sources" table at the end of this Alert for a list of Internet resources, including some Web sites that can provide additional information on regulatory issues and developments.

that the transaction confirmations for these accounts disclose specific information and notify customers that certain additional information will be available upon written request. The new rule also exempts broker-dealers effecting transactions for customers in security futures products in a futures account from the disclosure requirements of Exchange Act Section 11(d)(2). Effective date: October 15, 2002. Compliance dates: October 15, 2002, and June 1, 2003.

- *Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports.* In September 2002, the SEC adopted amendments to its rules and forms to accelerate the filing of quarterly and annual reports under the Exchange Act by domestic reporting companies that have a public float of at least \$75 million, that have been subject to the Exchange Act's reporting requirements for at least 12 calendar months, and that previously have filed at least one annual report. The changes for these accelerated filers will be phased in over three years. The annual report deadline will remain 90 days for year one and change from 90 days to 75 days for year two and from 75 days to 60 days for year three and thereafter. The quarterly report deadline will remain 45 days for year one and change from 45 days to 40 days for year two and from 40 days to 35 days for year three and thereafter. The phase-in period will begin for accelerated filers with fiscal years ending on or after December 15, 2002. The SEC also adopted amendments to require accelerated filers to disclose in their annual reports where investors can obtain access to their filings, including whether the company provides access to its Forms 10-K, 10-Q, and 8-K reports on its Internet Web site free of charge, as soon as reasonably practicable after those reports are electronically filed with or furnished to the SEC. Effective date: 60 days after publication in the *Federal Register*. See Release No. 33-8128 for compliance date information.
- *Certification of Disclosure in Companies' Quarterly and Annual Reports.* In August 2002, the SEC adopted rules, as directed by Section 302(a) of the Sarbanes-Oxley Act of 2002, to require an issuer's principal executive and financial officers each to certify the financial and other information contained in the issuer's quarterly and annual reports. The rules also require these officers to certify that they are responsible for establishing, maintaining, and regularly evaluating the effectiveness of the issuer's internal controls; they have made certain disclosures to the issuer's auditors and the audit committee of the board of directors about the issuer's internal controls; and they have included information in the issuer's quarterly and annual reports about their evaluation and whether there have been significant changes in the issuer's internal controls or in other factors that could significantly affect internal controls subsequent to the evaluation. In addition, the SEC adopted previously proposed rules to require issuers to maintain, and regularly evaluate the effectiveness of, disclosure controls and procedures designed to ensure that the information required in reports filed under the Exchange Act is recorded, processed, summarized, and reported on a timely basis. Effective date: August 29, 2002.
- *Ownership Reports and Trading by Officers, Directors and Principal Security Holders.* In August 2002, the SEC adopted rule and form amendments to implement the accelerated filing deadline applicable to change of beneficial ownership reports required to be filed by officers, directors, and principal security holders under Section 16(a) of the Exchange Act, as amended by the Sarbanes-Oxley Act of 2002. The amendments are intended to facilitate the statutory changes, which became effective August 29, 2002, consistent with their purpose. Effective date: August 29, 2002.
- *Customer Margin Rules Relating to Security Futures.* See the "Commodity Futures Trading Commission Regulations" section of this Alert for a detailed discussion of this regulation.
- *Assessments on Security Futures Transactions and Fees on Sales of Securities Resulting from Physical Settlement of Security Futures Pursuant to Section 31 of the Exchange Act.* In July 2002, the SEC adopted an amendment to a rule under the Exchange Act to clarify how to calculate assessments that are required to be paid by national securities exchanges and national securities associations pursuant to Section 31(d) of the Exchange Act for security futures transactions. In addition, the amendment provides guidance on how to calculate fees that are required to be paid by national securities exchanges and national securities associations pursuant to Sections 31(b) and (c) of the Exchange Act, respectively, for sales of securities that result from the physical settlement of security futures. Effective date: August 12, 2002.

- *Technical Amendments to Rules and Forms Due to the National Securities Markets Improvement Act of 1996 and the Gramm-Leach-Bliley Act.* In June 2002, the SEC adopted technical amendments to rules and forms under the Investment Company Act of 1940 (Investment Company Act) and the Exchange Act. The amendments correct statutory references currently included in the rules and the forms. Effective date: July 8, 2002.
 - *Cash Settlement and Regulatory Halt Requirements for Security Futures Products.* See the “Commodity Futures Trading Commission Regulations” section of this Alert for a discussion of this rule.
 - *Mandated EDGAR Filing for Foreign Issuers.* In May 2002, the SEC adopted amendments to the rules that govern its electronic data gathering, analysis, and retrieval (EDGAR) system. These amendments require foreign private issuers and foreign governments to file electronically through the EDGAR system most of their securities documents, including registration statements under the Securities Act of 1933 (Securities Act) and registration statements, reports, and other documents under the Exchange Act. The SEC also adopted rule amendments to clarify when an electronic or paper filer may submit an English summary instead of an English translation of a foreign language document. The SEC further eliminated the current requirement that any first-time EDGAR filer, domestic or foreign, submit a paper copy of its electronic filing to the Commission. Finally, the SEC permitted a national securities exchange to file voluntarily on EDGAR a Form 25, which reports the delisting of a class of a company’s securities. Effective date: November 4, 2002, except for Sections 232.101(d), 232.101(b)(10), and 232.101(c)(9), which are effective May 24, 2002.
 - *Amendment to Definition of “Equity Security.”* The CFMA amended the definition of “security” in the Securities Act and the definitions of “security” and “equity security” in the Exchange Act to include a security future. In April 2002, the SEC amended the definitions of “equity security” in the rules under the Securities Act and the Exchange Act to conform them to the statutory definitions with respect to security futures. Effective date: June 7, 2002.
 - *Exemption of Transactions in Certain Options and Futures on Security Indexes from Section 31 of the Exchange Act.* In January 2002, the SEC, by rule, exempted two classes of securities from the fee and assessment requirements of Section 31 of the Exchange Act: options on narrow-based security indexes and futures on narrow-based security indexes. In light of the very low amount of Section 31 fees currently collected on options on narrow-based security indexes, the SEC granted the exemption for options on such indexes to relieve certain national securities exchanges of the burden of having to calculate whether an index is narrow-based or broad-based. The SEC granted the exemption for futures on narrow-based security indexes to promote a level playing field between options and futures. Effective date: February 1, 2002.
 - *Amendments to Rule 31-1, Securities Transactions Exempt From Transaction Fees.* In January 2002, the SEC amended the rule that provides an exemption from Section 31(c) of the Exchange Act for OTC transactions in OTC securities that are subject to unlisted trading privileges on a national securities exchange. One subparagraph of the rule has become obsolete and unnecessary due to the enactment of H.R. 1088, the Investor and Capital Markets Fee Relief Act. Effective date: January 16, 2002.
- .66 In addition, final rules that the SEC issued in 2001 since the writing of last year’s Audit Risk Alert include the following:
- *Options Disclosure Document.* In December 2001, the SEC adopted a revision to a rule under the Securities Act to clarify that an options disclosure document prepared in accordance with the SEC rules under the Exchange Act is not a prospectus and is not subject to civil liability under Section 12(a)(2) of the Securities Act. This amendment codifies a long-standing interpretive position taken by the Division of Corporation Finance soon after the SEC adopted the current registration and disclosure system applicable to standardized options in 1982. The SEC codified this position to reduce the legal uncertainty regarding the liability issue. Effective date: February 1, 2002.

- **Disclosure of Equity Compensation Plan Information.** In December 2001, the SEC adopted amendments to the Exchange Act disclosure requirements applicable to annual reports filed on Forms 10-K and 10-KSB and to proxy and information statements. The amendments are intended to enhance disclosure of the number of outstanding options, warrants, and rights granted by registrants to participants in equity compensation plans, as well as the number of securities remaining available for future issuance under these plans. The amendments require registrants to provide this information separately for equity compensation plans that have not been approved by their security holders, and to file with the SEC copies of these plans unless immaterial in amount of significance. Effective date: 30 days after publication in the *Federal Register*. Compliance dates: Registrants must comply with the new disclosure requirements for their annual reports on Forms 10-K or 10-KSB to be filed for fiscal years ending on or after March 15, 2002, and for proxy and information statements for meetings of, or action by, security holders occurring on or after June 15, 2002. Registrants voluntarily may comply with the new disclosure requirements before the compliance dates.

Other Recent SEC Developments

.67 The following is a brief discussion of some other SEC developments that might be of interest to the auditors of securities firms.

SEC Interpretive Release, Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules thereunder to Trading in Security Futures Products³

.68 In June 2002, the SEC published its views regarding the application of certain provisions of the federal securities laws to trading in security futures products. On December 21, 2000, Congress enacted the Commodity Futures Modernization Act (CFMA), addressing the regulation of security futures products. Security futures products are securities for purposes of the federal securities laws, including the Securities Act and the Exchange Act, and are “futures” for purposes of the Commodity Exchange Act (CEA). Because these products are both securities and futures, the CFMA established a framework for the joint regulation of these products by the SEC and the CFTC. Security futures products must be traded on trading facilities and through intermediaries that are registered with both the SEC and the CFTC. Given this new regulatory framework, various industry participants have requested guidance regarding the application of certain provisions of the federal securities laws to trading in security futures products. The guidance is effective June 27, 2002.

Other SEC Information

.69 **SEC Section 31 Fees.** SEC Section 31 fees are collected from customers and remitted to the SEC through NASD and national securities exchanges, such as the NYSE and the AMEX, or are directly charged to brokers as part of their Securities Industry Automation Corporation (SIAC) daily settlement. Due principally to rounding differences, clients may be charged a higher fee than is submitted to either the regulators or to the SIAC. This difference has grown over the last few years and the SEC is now requesting the brokers to pay this overage directly to the SEC as opposed to allocating it back to customers.

.70 **Variable Annuities.** Suitability of variable annuities is a major focus of regulators who are concerned that investors do not fully understand the complexities of this product. The SEC is examining firms selling variable annuities to ensure that all features of this product are properly explained to customers. The fees

³ The SEC from time to time will provide guidance relating to topics of general interest to the business and investment communities by issuing an “interpretive release,” in which it publishes its views on the subject matter and interprets the federal securities laws and its own regulations. The SEC Interpretive Release *Commission Guidance to Broker-Dealers on the Use of Electronic Storage Media under the Electronic Signatures in Global and National Commerce Act of 2000 with Respect to Rule 17a-4(f)* is available on the SEC Web site at www.sec.gov

associated with this product, the potential costs to investors due to paying for the life insurance benefit, and the tax consequences of the product need to be communicated to the investor. In addition, the surrender charges are not well known and investors should be alert to these consequences. NASD Regulation (NASDR) also focused on the issue of suitability of variable annuities. NASDR recently brought several enforcement actions against firms for the improper marketing and sale of variable annuities. Rule 2310(a) of the NASD Conduct Rules provides that “in recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, described by such customer as to his other security holdings and as to his financial situation and needs.” Rule 2310(b) imposes upon a broker the duty to make reasonable efforts to obtain information concerning the customer’s financial status, tax status, investment objectives and other relevant information in making a recommendation to a customer. In various notices to members, the NASD has reminded members that they are subject to suitability requirements in connection with the sale of variable products and provided suitability guidelines for the sale of variable annuities and variable life products.

.71 Order Requiring the Filing of Sworn Statements Pursuant to Section 21(a)(1) of the Securities Exchange Act of 1934. The SEC has commenced an investigation to ascertain facts, conditions, practices, and other matters relating to the financial statements and accounting practices of certain large publicly traded companies. As part of this investigation, in June the SEC issued an order requiring written statements, under oath, from senior officers of certain publicly traded companies (the companies) with revenues during their last fiscal year of greater than \$1.2 billion that file reports with the SEC pursuant to the Exchange Act, regarding the accuracy of their companies’ financial statements and their consultation with the companies’ audit committees. Effective date: August 14, 2002.

.72 Commission Statement about Management’s Discussion and Analysis of Financial Condition and Results of Operations. In January 2002, the SEC issued a statement regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A). The release sets forth certain views of the SEC regarding disclosure that should be considered by registrants. Disclosure matters addressed by the release are liquidity and capital resources including off-balance sheet arrangements; certain trading activities that include non-exchange traded contracts accounted for at fair value; and effects of transactions with related and certain other parties. In November 2002, the SEC proposed a new rule, *Disclosure in Management’s Discussion and Analysis About Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments*, which would require disclosure of off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of an issuer with unconsolidated entities or other persons that have, or may have, a material effect on financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources. The new disclosure would be located in the MD&A section in a company’s disclosure documents. The proposals would require a registrant to provide, in a separately captioned subsection of MD&A, a comprehensive explanation of its off-balance sheet arrangements. The proposals also would require a registrant (other than small business issuers) to provide an overview of its aggregate contractual obligations in a tabular format and contingent liabilities and commitments in either a textual or tabular format.

.73 Cautionary Advice Regarding Disclosure About Critical Accounting Policies. In December 2001 the SEC issued a statement regarding the selection and disclosure by public companies of critical accounting policies and practices. The purpose of this statement is to alert companies to the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation. The SEC encourages public companies to include in their MD&A full explanations, in plain English, of their “critical accounting policies,” the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. The objective of this disclosure is consistent with the objective of MD&A.

.74 In May 2002, the SEC proposed a new rule, *Disclosure in Management’s Discussion and Analysis about the Application of Critical Accounting Policies*, which would encompass disclosure in two areas: accounting estimates a company makes in applying its accounting policies and the initial adoption by a company of an

accounting policy that has a material impact on its financial presentation. Under the first part of the proposals, a company would have to identify the accounting estimates reflected in its financial statements that required it to make assumptions about matters that were highly uncertain at the time of estimation. Disclosure about those estimates would then be required if different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of the company's financial condition, changes in financial condition, or results of operations. A company's disclosure about these critical accounting estimates would include a discussion of the methodology and assumptions underlying them; the effect the accounting estimates have on the company's financial presentation; and the effect of changes in the estimates. Under the second part of the proposals, a company that has initially adopted an accounting policy with a material impact would have to disclose information that includes what gave rise to the initial adoption; the impact of the adoption; the accounting principle adopted and method of applying it; and the choices it had among accounting principles. Companies would place all of the new disclosure in the MD&A section of their annual reports, registration statements, and proxy and information statements. In addition, in the MD&A section of their quarterly reports, U.S. companies would have to update the information regarding their critical accounting estimates to disclose material changes.

.75 *Cautionary Advice Regarding the Use of "Pro Forma" Financial Information in Earnings Releases.* The SEC issued a statement regarding the use by public companies of pro forma financial information in earnings releases. The purpose of this statement is to caution public companies on their use of pro forma financial information and to alert investors to the potential dangers of such information. The SEC staff is concerned that pro forma financial information, under certain circumstances, can mislead investors if it obscures generally accepted accounting principles (GAAP) results. Because this pro forma financial information by its very nature departs from traditional accounting conventions, its use can make it hard for investors to compare an issuer's financial information with other reporting periods and with other companies. In November 2002, the SEC proposed a new rule entitled *Conditions for Use of Non-GAAP Financial Measures* to address public companies' disclosure or release of certain financial information that is derived on the basis of methodologies other than in accordance with GAAP. The SEC is proposing a new disclosure regulation, Regulation G, which would require public companies that disclose or release these non-GAAP financial measures to include, in that disclosure or release, a presentation of the most comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most comparable GAAP financial measure. The SEC is also proposing to amend Item 10 of Regulation S-K and Item 10 of Regulation S-B to provide additional guidance to those registrants that include non-GAAP financial measures in Commission filings. Additionally, the SEC is proposing to amend Form 20-F to incorporate the proposed amendments to Item 10 of Regulation S-K. Finally, the SEC is proposing to require registrants to file on Form 8-K earnings releases or similar announcements, with those filings subject to the guidance in amended Item 10 of Regulation S-K and Item 10 of Regulation S-B.

Help Desk—The text of these and other SEC releases are available on the SEC Web site at www.sec.gov.

Commodity Futures Trading Commission Regulations

.76 The following is a summary of some of the rulemakings and orders issued by the Commodity Futures Trading Commission (CFTC or the Commission) during 2002.

Implementing the Commodity Futures Modernization Act

.77 The Commodity Futures Modernization Act (CFMA), which became law on December 21, 2000, establishes a framework for the joint regulation of the trading of futures contracts on single securities and on narrow-based security indexes (collectively "security futures") by the CFTC and the SEC. Previously, security futures were statutorily prohibited from trading in the United States. Several rulemakings and orders were issued during 2002 to address the trading of security futures. A summary of some of these rulemakings and orders is set forth below:

.78 *Applicability of CFTC and SEC Customer Protection, Recordkeeping, Reporting, and Bankruptcy Rules and the Securities Investor Protection Act of 1970 to Accounts Holding Security Futures Products.* The CFMA directs the CFTC and SEC to address certain duplicative or conflicting regulations to any firm that is fully registered both as a futures commission merchant (FCM) with the CFTC and a securities broker-dealer (BD) with the SEC. There are approximately 90 such firms. The principal area where this was an issue is the protection of customer funds. In the futures industry, segregation of customer funds from an FCM's proprietary funds is required; the securities regime requires account insurance that is administered by the Securities Investor Protection Corporation (SIPC).

.79 The CFTC and SEC adopted final rules in this area on September 9, 2002. For the firms that are fully-registered as both FCMs and BDs, in the first instance it is their choice as to whether security futures products (SFPs) will be held in futures or securities accounts. These firms may also permit some or all of their customers to make that election. Futures accounts will be protected by the segregation of funds framework, and securities accounts will be entitled to SIPC coverage. These firms must also establish written policies concerning how SFPs will be held.

.80 All firms that are involved in SFP transactions, even those that are not dually registered with both the CFTC or SEC, must disclose to SFP customers the protections provided by segregation and by SIPC regulatory frameworks, the regulatory framework that is applicable to customer accounts, and the fact that the alternative regulatory framework is not applicable. For FCMs that do not register as full BDs with the SEC, only segregation is available; a BD that does not fully register as an FCM with the CFTC may only provide SIPC coverage.

.81 This regulation became effective September 13, 2002, except for section 240.17a-4(l) and (m) which became effective May 2, 2003.

.82 *Customer Margin Rules Relating to Security Futures.* As part of the statutory scheme for the regulation of security futures, the CFMA provided for the issuance of rules governing customer margin for transactions in security futures. Specifically, the CFMA directed the Federal Reserve Board to prescribe rules establishing initial and maintenance customer margin requirements. Pursuant to joint authority delegated by the Federal Reserve Board, in August 2002 the CFTC and SEC issued customer margin rules that became effective September 13, 2002.

.83 The CFMA provides that the customer margin requirements for security futures must satisfy four requirements. First, they must preserve the financial integrity of markets trading security futures products. Second, they must prevent systemic risk. Third, they must be consistent with the margin requirements for comparable exchange-traded security options, and provide for initial and maintenance margin levels that are not lower than the lowest level of margin, exclusive of premium, required for comparable exchange-traded security options. Fourth, they must be and remain consistent with the margin requirements established by the Federal Reserve Board under Regulation T (which governs the initial margin requirements for all securities other than exempted securities and security futures products).

.84 The customer margin rules for security futures, among other things:

1. Establish minimum initial and maintenance margin levels for outright positions in security futures at 20 percent of their "current market value," as defined in the rules.
2. Permit exchanges to set margin levels lower than 20 percent of current market value for customers with certain strategy-based offset positions involving security futures and one or more related securities or futures.
3. Establish stand-alone requirements that are consistent with Regulation T, but, unlike the proposed rules, do not apply Regulation T in its entirety to futures accounts.

4. Identify the types of collateral acceptable as margin deposits and establish standards for the valuation of such collateral and other components of equity.
5. Set forth procedures applicable to undermargined accounts.

.85 Prior to commencing trading, exchanges must obtain the SEC's approval for exchange rules governing margin for security futures. They also must either certify to the CFTC that the rules do not violate the Commodity Exchange Act or CFTC rules, or obtain the CFTC's prior approval for the rules.

.86 *Cash Settlement and Regulatory Halt Requirements for Security Futures Products.* In May 2002, the CFTC and the SEC (the Commissions) adopted a new rule generally to require that the final settlement price for each cash-settled security futures product fairly reflect the opening price of the underlying security or securities, and that trading in any security futures product halt when a regulatory halt is instituted with respect to a security or securities underlying the security futures product by the national securities exchange or national securities association listing the security. The rule would set forth more specifically how the exchange's or association's rules can satisfy provisions added to the Commodity Exchange Act (CEA) and the Exchange Act by the CFMA. The Commissions also issued an interpretation of the statutory requirement under the CEA and the Exchange Act that procedures be put in place for coordinated surveillance among the markets trading security futures products and any market trading any security underlying the security futures products or any related security. Effective date: June 24, 2002.

Additional Rulemakings and Orders Issued During 2002

.87 *Denomination of Customer Funds and the Location of Depositories.* On August 7, 2002, the Commission published in the *Federal Register* a proposed new rule that would permit FCMs and derivative clearing organizations (DCOs), under certain conditions, to deposit customer funds in foreign depositories and in certain currencies other than U.S. dollars. Specifically, the proposal would provide that FCM obligations owed to customers may be held in: (1) U.S. dollars; (2) in a currency in which funds were deposited by the customer, or converted at the request of the customer, to the extent of such deposits and conversions; or (3) in a currency in which funds have accrued to the customer as a result of trading on a designated contract market. Additionally, the rule would permit an FCM or DCO to hold customer funds of any denomination in the U.S. or any money center country (defined in the proposal as the G7 countries) or in the country of origin of the currency.

.88 The proposed rule also includes an amendment to Appendix B of the Commission's bankruptcy rules that would govern the distribution of property where the bankrupt FCM or DCO maintains customer property in depositories outside the U.S. or in a currency other than U.S. dollars. This new distributional framework is intended to assure that customers whose funds are held in a U.S. depository will not be adversely affected by a shortfall in the funds held in a depository outside the U.S. that is due to the sovereign action of a foreign government or court. The proposed rule would replace Financial and Segregation Interpretation No. 12.

.89 *Treatment of Funds Held in Connection With the Clearing of Over-the-Counter Products by the New York Mercantile Exchange.* On May 30, 2002, the Commission issued an Order permitting the New York Mercantile Exchange (NYMEX) Clearing House and FCMs clearing through the NYMEX Clearing House, subject to specified terms and conditions, to commingle customer funds used to margin, secure, or guarantee transactions executed in the OTC markets with other customer funds held in segregated accounts maintained in accordance with the customer segregation provisions of Section 4d of the Commodity Exchange Act and Commission regulations.

.90 *Withdrawal of FCM or IB Registration.* Commission Rule 3.33(c) was amended to no longer require an FCM or independent introducing broker (IB) to submit a financial statement Form 1-FR-FCM or 1-FR-IB to National Futures Association (NFA) as part of its request to withdraw its registration. This rule was effective June 6, 2002.

.91 *Review of 1-FR Financial Reports.* The Commission continues to enhance its software for reviewing financial reports submitted by FCMs and IBs. RSR Express is a software program which Commission staff use to receive, process, review, and track financial reports received electronically from FCMs and IBs. The Commission receives and reviews approximately 175 FCM financial reports each month. The Commission is the only entity, regulatory or otherwise, that receives financial reports from all registered FCMs.

.92 FCMs e-mail their financial reports to the Commission. An auto processor reads a prescribed mailbox every two minutes, processes newly received financial reports, and sends an automatic confirmation to the filing FCM. RSR Express also notifies Commission staff that a financial report has been received.

.93 RSR software contains a comprehensive set of analytical tools and edit checks which greatly assist Commission staff in their review of reported financial data to ensure continued compliance with the Commission's net capital and customer protection rules. The analytical tools allow the reviewer to compare historical financial data to current data. The edit checks alert the staff to possible problems with the financial reports. RSR also contains important tools that allow staff to track the receipt of financial reports (whether due, received, or overdue) and the status of the reports in the review process, from original review to final signoff.

.94 The Commission on a monthly basis queries RSR for key financial data, which is then posted on the Commission's Web page at www.cftc.gov/tm/tmfcm.htm.

Help Desk—The complete text of the preceding rules, along with other CFTC final rules, including those rules adopted, or changes made, subsequent to the writing of this Audit Risk Alert, can be downloaded from the CFTC's Web site at www.cftc.gov.

Commodity Futures Trading Commission Annual "Dear CPO" Letter

.95 On February 1, 2002, CFTC staff sent a letter to all commodity pool operators (CPOs), which outlined key reporting issues and common reporting deficiencies found in annual reports for commodity pools. The letter pointed out the CFTC staff's concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. CFTC staff suggested that CPOs share the letter with their independent auditors.

.96 Addressed in the letter as major concerns are:

- New anti-money laundering requirements
- Applicability of GAAP to commodity pools' annual financial statements
- New investment companies guide
- Schedule of investments required for calendar year 2001 annual reports under GAAP
- Fund-of-funds considerations
- Master-feeder structures
- Extended due dates for fund-of-funds pools

.97 In order to avoid some of the most common and easily remedied deficiencies the letter suggested that CPOs do the following:

- File one copy of the report with the National Futures Association (NFA) and two copies with the CFTC at the regional office in whose jurisdiction the CPO's principal place of business is located (the addresses are attached to the letter).

- File the report as soon as possible, but no later than the due date. For pools with a December 31, 2002, year end, the due date is Monday, March 31, 2003 (unless an extension of time has been granted). CPOs operating a fund-of-funds pool should review the streamlined procedures described in Regulation 4.22(f)(2) for requesting an extended due date.
- Include a signed oath or affirmation, as required by Regulation 4.22(h), with each and every copy of the report, including those copies filed with NFA and the CFTC. Omitting the oath was the most common deficiency noted in 2001 annual reports. (Binding the oath as part of the report package or attaching it to the cover page is a helpful practice followed by a number of CPOs.)
- If the pool is operating under a Rule 4.7 or 4.12 exemption, the rule requires that a notation of that fact be made on the cover page of the report.
- Report special allocations of partnership equity as required by CFTC Interpretive Letter 94-3, *Special Allocations of Investment Partnership Equity*. (The letter is available at the CFTC Web site at www.cftc.gov/tm/tm94-03.htm.)
- Include information concerning net asset values or schedules of participants' interests, as required by Regulation 4.22(c)(2).
- Include appropriate footnote disclosures with unaudited financial statements.

.98 Copies of the February 10, 1999, January 19, 2000, January 12, 2001, and February 1, 2002, "Dear CPO" letters are available at the CFTC Web site, www.cftc.gov, under the heading "Law & Regulation, Compliance." Future "Dear CPO" letters also will be available on the CFTC's Web site.

Self-Regulatory Organization Regulations

.99 Under the Exchange Act, all broker-dealers are required to be members of self-regulatory organizations (SROs) such as the NYSE or NASD, or other organization which performs routine surveillance and monitoring of its members. During the past year, a number of significant regulations were issued by SROs. Among these were the following:

- *Order With Respect to the Implementation of Nasdaq's SuperMontage Facility.* In January 2001, the SEC approved a rule change submitted by NASD, on behalf of the Nasdaq Stock Market, Inc. (Nasdaq), that would establish a new order display and collection facility for Nasdaq-listed securities (SuperMontage). To address the concerns expressed by several market participants that certain SEC rules would effectively make their participation in the SuperMontage mandatory, the SEC conditioned its approval of the SuperMontage on the implementation of an alternative display facility (ADF) by the NASD. On July 24, 2002, the Division of Market Regulation approved operation of the ADF as a pilot program for nine months (see below). Based on this and other developments, the SEC believes that participation in SuperMontage will be voluntary, because market participants will have alternative venues in which to display their quotes, including the ADF. In September, the SEC authorized the Nasdaq to begin operation of its SuperMontage facility on or after October 11, 2002 (see Release Nos. 34-46429 and 2002-134).
- *Operation of the Alternative Display Facility for Quoting and Trading in Securities of The Nasdaq Stock Market, Inc.* In July 2002, the SEC approved the NASD's ADF for Nasdaq stocks for a nine-month pilot period. The pilot period is to expire at the close of daily operation of the ADF Pilot on April 24, 2003.
- *Order Granting Temporary Exemption for Broker-Dealers from the Trade-Through Disclosure Rule.* In May 2002, the SEC temporarily exempted until January 1, 2003, broker-dealers from compliance with the Trade-Through Disclosure Rule for exchange-traded funds.
- *Research Analyst Conflicts of Interest.* In May 2002, the SEC approved proposed rule changes by the NASD and NYSE relating to research analyst conflicts of interest. The SROs proposed to amend their rules to address conflicts of interest that are raised when research analysts recommend securities in

public communications. According to a joint memorandum issued by the NASD and the NYSE, generally, the SRO rules would restrict the relationship between research and investment banking departments; require disclosure of financial interest in covered companies by the analyst and the firm; require disclosure of existing and potential investment banking relationships with subject companies; impose quiet periods for the issuance of research reports; restrict personal trading by analysts; and require disclosure of information that helps investors track the correlation between an analyst's rating and the stock's price movements. Effective date: the rules become effective over the period from July 9, 2002, to November 6, 2002.

- *Anti-Money Laundering Compliance Programs.* See "Money Laundering Activities" in the "Audit and Accounting Issues and Developments" section of this Alert for a discussion of this rule.
- *Order Granting Approval to Proposed Rule Change Relating to Revisions to Form U-4 and Form U-5.* In March 2002, the SEC approved NASD proposed rule change revising the Uniform Application for Securities Industry Registration or Transfer (Form U-4) and Uniform Termination Notice for Securities Industry Registration (Form U-5).

.100 The following is a summary of some of the financial-related rules adopted by the NFA, an SRO for commodity futures, during the past year:

- *Changes to Capital Requirement.* Amended the risk-based capital computation requirement to eliminate calculating risk on naked long option positions, conforming to the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME) changes. In addition, the charge was eliminated for remote locations and associated persons for FCMs with adjusted net capital of \$2 million or greater and introducing brokers with adjusted net capital of \$1 million or greater. The changes were effective December 31, 2001.
- *Electronic Filing of Financial Reports.* Required that all financial reports be filed electronically using WinJammer 4.0 software.
- *Filing Financial Statements Monthly.* Required that FCMs, for which the NFA is the designated SRO, submit monthly financial statements within 17 business days of the date of the statement.
- *Filings with Other SROs.* Required that FCMs and independent IBs file copies with the NFA of any financial reports or statements filed with other SROs.

Audit and Accounting Issues and Developments

Fraudulent Financial Reporting

.101 The dismal economic and business environment can generate increased pressure on the management of broker-dealers to commit fraud. The already strong pressures to achieve earnings goals and to battle fierce competition within the securities industry become even more intense during periods of economic decline. Auditors should also consider the implications of the stock market volatility on the risk of fraud by their broker-dealer clients. Auditors should note that, along with client bankruptcy, fraud is one of the more common reasons for litigation against auditors.

.102 In 2002 the AICPA Auditing Standards Board (ASB) issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), which supersedes SAS No. 82, which carried the same title, and amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230). The new Standard does not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec.

110.02). However, SAS No. 99 establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS). Discussed below are some of the more significant changes from SAS No. 82 and the effects on audits.

New Context for Considering Risks

.103 To provide a richer understanding of the environment in which fraud is likely to occur, the new SAS expands the description of fraud and its characteristics. It describes three conditions generally present when fraud occurs—incentive/pressure, opportunity, and attitude/rationalization. Input from forensic experts, academics, and others consistently showed that evaluation of information about fraud was enhanced when auditors considered it in the context of these three conditions.

Team Discussion and Professional Skepticism

.104 To increase awareness and sensitivity to fraud, and to enhance the fraud risk assessment process, SAS No. 99 requires audit team members to discuss during the planning stage the potential for material misstatements due to fraud. The more experienced team members should share their insights, and all the members should exchange ideas about how and where the entity's financial statements might be susceptible to material misstatements due to fraud.

.105 The new SAS also emphasizes the importance of maintaining the proper mindset throughout the audit regarding the potential for material misstatement due to fraud, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Consequently, the audit team's discussion would acknowledge fraud can occur in any entity and be perpetrated by anyone.

Expanded Inquiries

.106 SAS No. 99 requires auditors to query management on its views of the risks of fraud in the entity and knowledge of any known or suspected fraud. It also says auditors should query others—for example, individuals outside the entity's accounting or financial reporting areas or employees with varying levels of authority. This requirement is not intended to be onerous—the nature and extent of these inquiries would be based on the auditor's professional judgment and generally directed to employees with whom the auditor comes into contact during the course of the audit.

Expanded Scope for Assessing Fraud Risks

.107 SAS No. 99 emphasizes obtaining a broader range of information to serve as the foundation for an assessment that goes beyond considering the fraud risk factors provided in SAS No. 82. The various sources of information—inquiries of management and others, consideration of fraud risk factors, the results of the analytical procedures performed in planning the audit, and certain other information—all feed into the auditor's evaluation of fraud risks.

.108 The auditor uses the information to consider the *type* of risk that may exist (that is, whether it involves fraudulent financial reporting or misappropriation of assets), the *significance* or magnitude of that risk, the *likelihood* it will result in a material misstatement in the financial statements and the *pervasiveness* of the risk (that is, whether the potential risk is pervasive to the financial statements as a whole or specifically related to a particular assertion, account, or class of transactions).

Risks Related to Revenue Recognition

.109 Revenue recognition issues have been at the center of numerous instances of fraudulent financial reporting and continue to be the number one reason for restating financial statements. To address this problem, SAS No. 99 says auditors should ordinarily presume that there is a risk of material misstatement

due to fraud relating to revenue recognition. In planning the audit, auditors are now required to perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may be indicative of a material misstatement due to fraudulent financial reporting. The new SAS also provides examples of auditing procedures that auditors may want to consider related to the risk of improper revenue recognition.

Evaluating Programs and Controls

.110 When the auditor identifies risks of material misstatement due to fraud, SAS No. 99 requires that he or she consider management's programs and controls to address those risks. They might include broader programs or specific controls designed to prevent, deter, or detect fraud. As in SAS No. 82, the auditor has to consider whether such programs and controls will mitigate or exacerbate those identified risks. However, in a change from SAS No. 82, the auditor should evaluate whether these programs and controls have been suitably designed and placed in operation. The auditor's ultimate assessment of the risks of material misstatement due to fraud should take this evaluation into account.

Auditor's Response

.111 The new SAS requires the auditor to develop an appropriate response for each fraud risk identified and includes more extensive guidance and examples on how to do so. The auditor's responses, which are influenced by the nature and significance of the risks identified and the evaluation of the entity's programs and controls, might have an overall effect on how the audit is conducted (for example, additional persons with specialized skills or knowledge may be assigned) or might involve changing the nature, timing, or extent of auditing procedures for specific accounts or assertions. The response typically also will involve performing certain procedures to address the risk of management override of controls.

.112 Management is in a unique position to perpetrate fraud because it can override established controls that would appear to be operating effectively. This risk exists in virtually all audits and can occur in a number of unpredictable ways. Currently, the auditor's planned procedures in response to inherent and control risks and the auditor's assessment of the risk of material fraud consider, at least implicitly, the risk of management override. SAS No. 99, however, requires auditors to perform certain procedures to further address this risk. These procedures include:

- *Examining journal entries and other adjustments for evidence of possible material misstatement due to fraud.* Many auditors already may review unusual or "nonstandard" journal entries. However, SAS No. 99 requires the auditor to design procedures to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements (for example, entries posted directly to financial statement drafts).
- *Reviewing accounting estimates for biases that could result in material misstatement due to fraud.* Existing auditing standards already require the auditor to consider the potential for management bias when reviewing significant estimates. In addition, SAS No. 99 requires auditors to perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management.
- *Evaluating the business rationale for significant unusual transactions.* Although the auditor typically gains an understanding of significant transactions, SAS No. 99 places a greater focus on understanding the underlying business rationale for significant unusual transactions. In this context, unusual transactions are those that come to the auditor's attention that are outside the normal course of business for the company or that otherwise appear unusual.

.113 The new standard also requires auditors to design tests that would be unpredictable and unexpected by the client. During the audit, the engagement team should test areas, locations and accounts that otherwise might not be tested.

.114 SAS No. 99 includes an Exhibit, "Management Antifraud Programs and Controls: Guidance to Help Prevent, Deter, and Detect Fraud." It also includes an amendment to SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333.06 and .16), since SAS No. 99 requires the auditor to make inquiries of management about fraud and the risk of fraud. In support of and consistent with these inquiries, the amendment revises the guidance for management representations about fraud currently found in SAS No. 85.

.115 SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 31, 2002. Early application of the provisions of SAS No. 99 is permissible.

.116 The AICPA has developed a fraud Practice Aid titled *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*, which will be published by the end of 2002. The Practice Aid includes topics such as how the new SAS changes audit practice, characteristics of fraud, understanding the new SAS, best practices, and practice aids such as specialized industry fraud risk factors (including for brokers and dealers in securities), common frauds, and extended audit procedures. Auditors should consider using the guidance in the Practice Aid to help them implement SAS No. 99.

Going-Concern Issues

.117 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 have certain 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).

.118 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.

.119 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, noncompliance with various rules and regulations, 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. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

.120 If there is substantial doubt about the entity's ability to continue as a going concern, you 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 you obtain sufficient competent evidential matter to alleviate doubts about going-concern issues, then consideration should be given to the possible effects on the financial statements and the adequacy of the related disclosures.⁴ In particular, the auditor should consider

⁴ Statement on Auditing Standards (SAS) No. 96, *Audit Documentation*, amended 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), by adding a requirement for the auditor to document (a) the conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern; (b) the work performed in connection with the auditor's evaluation of management's plans; (c) the auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated; and (d) the consideration and effect of that conclusion on the financial statements, disclosures, and the audit report.

the adequacy of the disclosures of those circumstances and events that originally gave rise to the auditor's concern. If, however, after considering identified conditions and events, along with management's plans, you conclude 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 you should refer to the specific guidance set forth under SAS No. 59.

Pressure on Management to Perform

.121 The increasing competition from megabanks as well as from within the securities industry itself generates more intense pressure on management to perform and meet earnings and revenue expectations. 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, aggressive accounting methods, and internal control weaknesses.

Risk of Material Misstatement Due to Fraud

.122 The AICPA fraud Practice Aid titled *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide* (scheduled to be published by the end of 2002) will list a number of risk factors that may indicate an increased risk of fraudulent financial reporting at a broker-dealer, including the following:

- High-degree of competition relating to bank-owned broker-dealers that have been granted expanded powers to engage in securities activities, registered investment companies/mutual funds, accompanied by declining margins
- The pressure on management to meet the expectations of analysts and rating agencies
- Unusually high level of internal competition for capital allocation among product types/trading desks
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend

.123 Some of these factors and conditions may be present in entities where specific circumstances do not present a risk of material misstatement. Also, specific controls may exist which mitigate the risk of material misstatement due to fraud, even though risk factors or conditions are present. When identifying risk factors and other conditions, the auditor should assess whether those risk factors and conditions, individually and in combination, present a risk of material misstatement of the financial statements.

Aggressive Accounting

.124 To achieve expected results or report improved financial results, management may adopt aggressive accounting positions. Auditors should be alert to aggressive accounting positions taken by management and determine whether the accounting is appropriate under the circumstances.

Overriding Internal Control

.125 Management engaged in a severely competitive environment may aggressively engage in transactions that bypass normal internal control. 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 in their consideration of the nature, timing, and extent of their auditing procedures.

Litigation, Claims, and Assessments

.126 As discussed in the "Economic and Industry Developments" section of this Alert, the securities industry saw an increase in the number of arbitrations and lawsuits this year. According to the SEC, most of

the complaints allege misrepresentations, unauthorized trading, and unsuitable recommendations. As an auditor of a securities firm involved in legal proceedings, you need to evaluate management's consideration of the financial accounting and reporting implications of those proceedings pursuant to FASB Statement No. 5, *Accounting for Contingencies*. FASB Statement No. 5 addresses the accounting and reporting for loss contingencies, including those arising from litigation, claims, and assessments.

.127 Auditors need to be aware of their responsibilities under SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337). SAS No. 12 provides guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for the financial accounting and reporting for such matters when performing an audit in accordance with GAAS. The SAS provides, in part, that auditors should obtain evidential matter relevant to the following factors:

- 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
- The period in which the underlying cause for legal action occurred
- The degree of probability of an unfavorable outcome
- The amount or range of potential loss

.128 Because the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of management of an entity, management is the primary source of information about such matters. Accordingly, the independent auditor's procedures with respect to litigation, claims, and assessments should include the following:

- 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, ordinarily in writing, that they have disclosed all such matters required to be disclosed by FASB Statement No. 5.
- Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.
- 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. In addition, the auditor, with the client's permission, should inform the lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter.

.129 An auditor ordinarily does not possess legal skills, and therefore cannot make legal judgments concerning information coming to his or her attention. Accordingly, the auditor should request that the client's management send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

.130 Auditors also need to be aware that contingent liabilities could result in an increase in a broker-dealer's aggregate indebtedness and, accordingly, its net capital requirement. According to a comment from the SEC to NASD, a broker-dealer that is the subject of a lawsuit that could have a material impact on its net capital must obtain an opinion of counsel regarding the potential effect of such a suit on the firm's financial condition. Absent such opinion, the item must be considered, at a minimum, a contingent liability and included in the calculation of aggregate indebtedness.

.131 The audit normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments. Such procedures might include reading minutes of meetings of stockholders, directors, and appropriate committees; reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents; obtaining information concerning guarantees from bank confirmation forms; and inspecting other documents for possible guarantees by the client.

Money Laundering Activities

.132 Criminals use financial institutions to launder the proceeds of crime. Omnibus providers of diversified financial services may be particularly vulnerable because they provide a broad range of financial services that money launderers want and need, often in higher risk jurisdictions.

.133 Criminals use a wide variety of financial institutions and professional advisers to launder the proceeds of crime and, according to the Treasury, brokers and dealers in securities may also be vulnerable. The evolving dynamics of the industry—mergers and acquisitions, broader product lines, new technologies, and new distribution channels—generate important business opportunities, but they also generate risks for securities firms, 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.

Money Laundering and Financial Statements

.134 Money launderers tend to use the business entity more as a conduit than as a means of directly expropriating assets. For this reason, money laundering is far less likely to affect financial statements than are such types of fraud as misappropriations and consequently is unlikely to be detected in a financial statement audit. In addition, other forms of fraudulent activity usually result in the loss or disappearance of assets or revenue, whereas money laundering involves the manipulation of large quantities of illicit proceeds to distance them from their source quickly and in as undetectable a manner as possible. However, money laundering activities may have indirect effects on an entity's financial statements.

.135 Money laundering is considered to be an illegal act and independent auditors have a responsibility under SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), to be aware of the possibility that illegal acts may have occurred, indirectly affecting amounts recorded in an entity's financial statements. In addition, 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 (for example, the entity's contingent liability resulting from illegal acts committed as part of the money laundering process) on the entity's financial statements, the auditor should apply auditing procedures specifically designed to ascertain whether an illegal act has occurred.

.136 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.

Financial Crimes Enforcement Network Advisories

.137 The Financial Crimes Enforcement Network (FinCEN) is the policy-making and law enforcement agency within the U.S. Department of the Treasury that supports law enforcement investigative efforts and fosters interagency and global cooperation against domestic and international financial crimes. FinCEN constantly issues advisories about transactions. These advisories normally instruct financial institutions to give enhanced scrutiny to any transaction originating in or routed through higher risk jurisdictions. Periodically, the federal government reviews and reassesses foreign government and financial system risk,

cooperation, and compliance and accordingly adds names to and removes names from the sanction lists. It should be emphasized that the issuance of these advisories does not mean that financial institutions should curtail legitimate business with these jurisdictions.

Compliance With the Bank Secrecy and Patriot Acts

.138 The Bank Secrecy Act (BSA), as recently amended by the Patriot Act, authorizes the U.S. Department of the Treasury (Treasury) to issue regulations requiring financial institutions, as defined under the BSA, to keep records and file reports that are determined to have a high degree of usefulness in criminal, tax, and regulatory matters, or in the conduct of intelligence or counter-intelligence activities; to protect against international terrorism; and to implement counter-money laundering programs and compliance procedures. Section 321(b) of the Patriot Act specifically added any futures commodity merchant (FCM), commodity pool operator (CPO), or commodity trading advisor (CTA) that is or is required to be registered with the SEC to the "financial institution" definition in the BSA. Treasury also has interpreted the term "broker or dealer in securities or commodities," which is a term that is included within the BSA's financial institution definition, as including an introducing broker (IB).

.139 The following is a brief summary of recent anti-money laundering regulatory developments:

Anti-Money Laundering Programs. Section 352 of the Patriot Act requires each financial institution, as defined in the BSA, to establish an anti-money laundering (AML) program, which, at a minimum, must contain the following components: (1) the development of internal policies, procedures, and controls; (2) the designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test programs. Section 352 became effective April 24, 2002. On April 22, 2002, the SEC approved NASD and NYSE proposed rule changes relating to AML compliance programs. Both the NASD and NYSE proposed rule changes require each member firm and member organization to establish and implement AML compliance programs designed to ensure ongoing compliance with the requirements of the BSA and the regulations promulgated thereunder. Each member firm is required to develop and implement a written AML program reasonably designed to achieve and monitor the member's compliance with the requirements of the BSA, and the implementing regulations promulgated thereunder by the Treasury. Each member organization's AML program must be approved, in writing, by a member of senior management. To help their members understand and implement the new rules related to AML programs, the NYSE issued Information Memo 02-21, *Approval of New Rule 445—Anti-Money Laundering Compliance Program*, and the NASD issued Special Notice to Members 02-21, *NASD Provides Guidance To Member Firms Concerning Anti-Money Laundering Compliance Programs Required By Federal Law*.

The NFA has issued a rule (NFA Compliance Rule 2-9(c)) and a related Interpretive Notice requiring each FCM and IB member of the NFA to establish and implement an AML program. The CFTC approved this rule on April 23, 2002. Treasury had deferred application of the AML program requirement for CPOs and CTAs until October 24, 2002. Recently, however, Treasury proposed a rule that will require certain unregistered investment companies, including commodity pools, to have AML programs. Because the proposed rule targets commodity pools, there may not be a need for a separate AML rule for CPOs. Treasury, however, may still issue a separate AML rule for CTAs.

Special Due Diligence Programs for Certain Foreign Accounts. In May 2002, Treasury issued a proposed regulation requiring U.S. financial institutions, including broker-dealers, FCMs, and IBs, to establish due-diligence policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts and private banking accounts that U.S. financial institutions establish and maintain for non-U.S. persons. In July 2002, Treasury issued an interim final rule which requires broker-dealers, FCMs, and IBs to comply with provisions relating to private banking accounts and defers their compliance with the provisions related to correspondent accounts. The interim final rule became effective on July 23, 2002. NYSE's Information Memo No. 02-34, *Special Due Diligence for Correspondent Accounts and Private Banking Accounts*, summarizes relevant provisions of the new rule.

Suspicious Activity Reports (SARs). On July 1, 2002, Treasury issued a final rule requiring broker-dealers to report to Treasury suspicious transactions that involve \$5,000 or more in funds or other assets. This rule is applicable to transactions after December 30, 2002. On August 5, 2002, Treasury published draft Form SAR-SF (Suspicious Activity Report by the Securities and Futures Industry). Once finalized, the form should be used by broker-dealers and may be used voluntarily by FCMs registered with the CFTC to report suspicious activity to Treasury. The readers may wish to refer to the NASD Notice to Members No. 02-47, *Treasury Issues Final Suspicious Activity Reporting Rule for Broker/Dealers*, for a discussion of this new regulation and the proposed form. Section 356(b) of the Patriot Act authorizes Treasury to issue rules requiring FCMs, CPOs, and CTAs to file SARs. Although Treasury has announced its intention to issue rules requiring FCMs and IBs to file SARs, rules have not yet been proposed.

Customer Identification and Verification Rules. On July 23, 2002, Treasury, along with the SEC, CFTC, and other federal financial regulators, issued proposed rules that would require certain financial institutions to establish minimum procedures for identifying and verifying the identity of customers seeking to open new financial accounts. These proposed rules implement Section 326 of the Patriot Act, which directs the issuance of regulations requiring financial institutions to implement reasonable procedures for (1) verifying the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintaining records of the information used to verify the person's identity; and (3) determining whether the person appears on any list of known or suspected terrorists or terrorist organizations. Section 326 specifies that final rules must take effect on or before October 25, 2002. However, on October 11, 2002, Treasury advised all financial institutions, including broker-dealers, FCMs, and IBs, that they will not be required to comply with Section 326 of the Patriot Act or the proposed rules issued by Treasury and the federal regulators on July 23 until final implementing regulations are issued and become effective.

Correspondent Accounts. On September 26, 2002, Treasury issued a final rule titled *Correspondent Accounts for Foreign Shell Banks; Recordkeeping and Termination of Correspondent Accounts for Foreign Banks*. The new rule prohibits certain financial institutions, including broker-dealers, from providing correspondent accounts to foreign shell banks; requires such financial institutions to take reasonable steps to ensure that correspondent accounts provided to foreign banks are not being used to indirectly provide banking services to foreign shell banks; requires certain financial institutions that provide correspondent accounts to foreign banks to maintain records of the ownership of such foreign banks and their agents in the United States designated for service of legal process for records regarding the corresponding account; and requires the termination of correspondent accounts of foreign banks that fail to comply with or fail to contest a lawful request of the Secretary of the Treasury or the Attorney General of the United States. The new rule is effective October 28, 2002.

Reports Concerning Transactions in Excess of \$10,000 in Currency. The BSA requires FCMs, IBs, CTAs, and CPOs to file on a Form 8300 a report concerning any transaction (or series of related transactions) in excess of \$10,000 or more in currency.

Reports Concerning Foreign Bank and Financial Accounts (FBAR). The BSA requires each United States person who has a financial interest in or signature or other authority over a bank, securities or other financial account in a foreign country to file an FBAR if the aggregate value of the financial account exceeds \$10,000 at any time during the calendar year. The term "financial account" includes any commodity interest account. The term "United States person" includes any SEC or CFTC registrant (for example, a broker-dealer, FCM, IB, CPO, or CTA) that is a citizen or resident of the United States, domestic partnership, domestic corporation, or a domestic estate or trust.

Information Sharing. On September 26, 2002, Treasury issued a final rule to encourage information sharing among financial institutions and federal government law enforcement agencies to the purpose of identifying, preventing, and deterring money laundering and terrorist activity. Under the new rule, certain financial institutions will be able to share information among themselves for the purpose of identifying and reporting suspected terrorism and money laundering once the financial institutions have notified FinCEN that they intend to share such information and that they will take adequate steps to

maintain confidentiality. Under the final rule, any financial institution that is required to establish and maintain an anti-money laundering program or is treated as having satisfied this requirement is eligible to share information. The rule became effective upon issuance.

Employee Layoffs

.140 Many entities are resorting to layoffs during this economic downturn to counter-balance reduced earnings. Significant layoffs can have a serious effect on an entity's internal control, financial reporting and accounting systems. For instance, employees who remain at the company may feel overwhelmed by their workloads, feel pressure to complete their tasks with little or no time to consider their decisions, and may be performing too many tasks and functions. The auditor may need to consider whether these situations exist and what their effect is on internal control. SAS No. 55, as amended, provides guidance on the auditor's consideration of an entity's internal control in an audit of financial statements in accordance with GAAS.

.141 Additionally, the auditor may need to consider the possible effects that key unfilled positions can have on internal control. Entities that have had strong financial reporting and accounting controls could see those controls deteriorate due to the loss of employees. Layoffs can also create additional exposure to possible internal fraudulent activities (for example, when an employee performs a job function that otherwise would be segregated). Recently issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by fraud. See the "Fraudulent Financial Reporting" section of this Alert for detailed discussion of this new standard.

.142 You may want to consider these issues in planning and performing the audit and in assessing control risk. Remember that gaps in key positions may represent reportable conditions that should be communicated to management and the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*.

.143 If the securities firm you are auditing is experiencing layoffs, management will need to properly account for employee-related termination charges such as severance packages, restructuring charges, and voluntary separation. In addition, management may need to properly account for outplacement services, bonuses, and educational allowances to assist employees in contending with the loss of their jobs. The following accounting literature provides guidance on accounting issues related to layoffs:

- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, establishes standards for accounting for curtailments and termination benefits, among other issues. Practitioners should refer to paragraphs 6 to 14 for guidance on curtailment and paragraphs 15 to 17 for guidance on termination benefits. FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, requires the effect of the curtailment (for example, the termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a segment of a business) to be recorded as a loss. Practitioners should refer to paragraphs 96 to 99 for guidance on how to account for plan curtailment. The Statement also provides guidance on how to measure the effects of termination benefits in paragraphs 101 and 102.
- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, requires that entities providing postemployment benefits to their employees accrue the cost of such benefits. Inactive employees include those who have been laid off, regardless of whether or not they are expected to return to work. Postemployment benefits that can be attributed to layoffs can include salary continuation, supplemental unemployment benefits, severance benefits, job training and counseling, and the continuation of benefits such as health care benefits and life insurance coverage.

FASB Statement No. 112 does not require that the amount of postemployment benefits be disclosed. The financial statement shall disclose if an obligation for postemployment benefits is not accrued because the amount cannot be reasonably estimated.

- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, addresses disclosures only and requires the disclosure of the amount of gain or loss recognized resulting from a settlement or curtailment. Additionally, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event is required to be disclosed.

AICPA 2002 Audit and Accounting Guide *Brokers and Dealers in Securities*

.144 AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, with conforming changes as of May 1, 2002 (the Guide), has been updated to reflect the issuance of recently issued authoritative pronouncements. The Guide is available through the AICPA's reSOURCE Online and reSOURCE CD-ROM products, as well as through a loose-leaf subscription service. Paperback editions of Audit and Accounting Guides can be purchased as well.

Help Desk—Subscriptions to AICPA reSOURCE, subscriptions to the loose-leaf service, and paperback copies of the Guide may be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077, or faxing a request to (800) 362-5066, or by going online to www.cpa2biz.com.

New Auditing and Attestation Pronouncements, Quality Control, and Other Guidance

.145 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, the *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i>
SAS No. 100	<i>Interim Financial Information</i>
Statement of Position (SOP) 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i>
SQCS No. 6	<i>Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>
Audit Guide	<i>Service Organizations: Applying SAS No. 70, As Amended</i>
Auditing Interpretation No. 4 of SAS No. 70	"Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls"
Auditing Interpretation No. 5 of SAS No. 70	"Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods"

Auditing Interpretation No. 14 of SAS No. 58	"Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing"
Auditing Interpretation No. 12 of SAS No. 1	"The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Changes in the Year of Adoption"
Auditing Interpretation No. 15 of SAS No. 58	"Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations"
Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Practice Alert 02-1	<i>Communications With the Securities and Exchange Commission</i>
Practice Alert 02-2	<i>Use of Specialists</i>
Practice Alert 02-3	<i>Reauditing Financial Statements</i>
Practice Aid	<i>Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide</i>
Practice Aid	<i>Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users (3rd edition)</i>

.146 The following summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

Related-Party Toolkit

.147 The AICPA staff has developed an electronic document, *Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors*, to provide accountants and auditors of private-sector business enterprises with an overview of selected authoritative accounting and auditing literature, SEC requirements, and nonauthoritative best practice guidance concerning related parties and related-party transactions. The related-party toolkit is available on the AICPA Web site at www.aicpa.org/public/download/news/relpty_toolkit.doc.

Practice Alert 02-1, *Communications With the Securities and Exchange Commission*

.148 The AICPA Securities and Exchange Commission Practice Section (SECPS) Executive Committee established a Professional Issues Task Force (PITF) which formulates guidance based on issues arising in peer reviews, firm inspections, and litigation to facilitate the resolution of emerging audit practice issues. This guidance takes the form of Practice Alerts. The information contained in these Practice Alerts is nonauthoritative. It represents the views of the members of the PITF and does not represent official positions of the AICPA.

.149 Practice Alert 02-1 provides registrants and their auditors with the most up-to-date information about when, why, and how they may wish to discuss SEC accounting, financial reporting, and disclosure issues and questions with the staff at the SEC. In addition, this Alert is intended to provide professionals with references to other resources that may be useful when working with SEC registrants.

Practice Aid *Fraud Detection in a GAAS Audit*—SAS No. 99 Implementation Guide

.150 In connection with the issuance of SAS No. 99, the AICPA is issuing a Practice Aid to help practitioners implement the new fraud guidance. The practice aid is entitled *Fraud Detection in a GAAS Audit* (product no. 006613kk) and will be available in December 2002. The Practice Aid includes topics such as:

- How the new SAS changes audit practice
- Characteristics of fraud
- Understanding the new fraud SAS
- Best practices
- Practice aids, such as:
 - Specialized industry fraud risk factors
 - Common frauds and extended audit procedures

The Practice Aid represents valuable guidance in helping practitioners understand and implement SAS No. 99.

New Accounting Pronouncements and Other Guidance⁵

.151 Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy*.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated with Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions, an amendment of FASB Statements No. 71 and 144 and FASB Interpretation No. 9</i>
SOP 01-5	<i>Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</i>
SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i>
Technical Practice Aids	<i>Software Revenue Recognition</i>
Questions & Answers	<i>FASB Statement No. 87, Employers' Accounting for Pensions</i>

On the Horizon

.152 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that may be relevant to your engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.153 The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web

⁵ Readers should refer to the full text of the accounting pronouncements that are discussed in this section of the Audit Risk Alert. Readers should also be alert for updates to the topics discussed in this section of the Alert, and for other recent Financial Accounting Standards Board (FASB) and SEC developments. Further information related to FASB projects can be obtained from the FASB Web site at www.fasb.org. Further information related to SEC rules and releases can be obtained from the SEC Web site at www.sec.gov.

sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed below. Readers should refer to information provided by the various standard-setting bodies for further information.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA’s standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate “exposure draft e-mail list” in the subject header field to help process your submission more efficiently. Include your full name, mailing address, and, if known, your membership and subscriber number in the message.

Auditing Pipeline

Exposure Draft on Auditing Fair Value Measurements and Disclosures

.154 The ASB has issued an exposure draft of a proposed SAS entitled *Auditing Fair Value Measurements and Disclosures*. The proposed SAS addresses auditing considerations relating to measurement, presentation, and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. A vote to ballot a document for final issuance is expected to occur in the autumn of 2002.

New Framework for the Audit Process

.155 The ASB has voted to expose a suite of seven proposed SASs relating to the auditor’s risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance the auditor’s application of the audit risk model in practice by requiring:

- A more in-depth understanding of the entity and its environment, including its internal control, that would better enable the auditor to identify the risks of material misstatement in the financial statements and any steps the entity is taking to mitigate them.
- A more rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- A better linkage between the assessed risks of material misstatement and the nature, timing, and extent of audit procedures performed in response to those risks.

.156 The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150)
- *Audit Evidence*, which would supersede SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)

- *Audit Risk and Materiality in Conducting an Audit*, which would supersede SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)
- *Planning and Supervision*, which would supersede “Appointment of the Independent Auditor” (AICPA, *Professional Standards*, vol. 1, AU sec. 310), and SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (Assessing Risks)
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, which would supersede SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and, together with the proposed SAS *Assessing Risks*, would supersede SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319)
- *Amendment to SAS No. 39, Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350)

You should keep abreast of the status of these projects and exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA’s Web site at www.aicpa.org.

Accounting Pipeline

Exposure Draft on Loans and Certain Debt Securities Acquired in a Transfer (Formerly Known as Purchased Loans and Securities)

.157 AcSEC has issued an exposure draft of a proposed SOP titled *Accounting for Loans and Certain Debt Securities Acquired in a Transfer*. This proposed SOP considers whether Practice Bulletin (PB) No. 6, *Amortization of Discounts on Certain Acquired Loans*, continues to be relevant given a number of FASB pronouncements issued subsequent to PB No. 6. The proposed SOP excludes originated loans from its scope. A final SOP is expected to be issued during the fourth quarter of 2002.

Consolidation of Certain Special-Purpose Entities

.158 The FASB has issued an exposure draft of a proposed Interpretation of Accounting Research Bulletin (ARB) No. 51 entitled *Consolidation of Certain Special-Purpose Entities*. This proposed Interpretation would address consolidation by business enterprises of special-purpose entities (SPEs) to which the usual condition of consolidation described in ARB No. 51, *Consolidated Financial Statements*, does not apply because the SPEs have no voting interest or otherwise are not subject to control through ownership of voting interests. A final Interpretation is expected to be issued during the fourth quarter of 2002.

Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others

.159 The FASB has issued an exposure draft of a proposed Interpretation of FASB Statements No. 5, 57, and No. 107, *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. This proposed Interpretation would elaborate on the disclosures to be made by a guarantor in its financial statements about its obligations under certain guarantees that it has issued. It also would require a guarantor to recognize, at the inception of a guarantee, a liability for the fair value of the obligations it has undertaken in issuing the guarantee. This proposed Interpretation does not address the subsequent measurement of the guarantor’s recognized liability over the term of the related guarantee. This proposed Interpretation also would incorporate, without change, the guidance in FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others*, which would be superseded.

.160 This proposed Interpretation would not apply to guarantee contracts issued by insurance and reinsurance companies and accounted for under specialized insurance accounting principles, a lessee’s

residual value guarantee embedded in a capital lease, contingent rents, and vendor rebates. The provisions related to recognizing a liability at inception for the fair value of the guarantor's obligations would not apply to product warranties, guarantees that are accounted for as derivatives, contingent consideration in a business combination, guarantees for which the guarantor's obligations would be reported as an equity item (rather than a liability), and an original lessee's guarantee of lease payments for which it remained secondarily liable in conjunction with being relieved of its primary obligation under a lease restructuring. However, those guarantees would be subject to the disclosure requirements of the proposed Interpretation. A final Statement is expected to be issued during the fourth quarter of 2002.

Amendment of FASB Statement No. 133 on Derivative Instruments and Hedging Activities

.161 The FASB has issued an exposure draft of a proposed Statement entitled *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. This proposed Statement would amend the definition of a derivative in paragraph 6(b) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This proposed Statement also would amend Statement No. 133 for various decisions made as part of the Derivatives Implementation Group process. A final Statement is expected to be issued during the fourth quarter of 2002.

Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment

.162 Proposed AICPA SOP *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment* and proposed FASB Statement *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment—an amendment of APB Opinions No. 20 and 28 and FASB Statements No. 51 and 67 and a rescission of FASB Statement No. 73* were issued simultaneously for public comment. Principally, the proposed FASB Statement would amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from its scope the accounting for acquisition, development, and construction costs of real estate developed and used by an entity for subsequent rental activities. The accounting for those costs would be subject to the guidance in the proposed SOP. It also would amend APB Opinion No. 28, *Interim Financial Reporting*, to require that those costs that the proposed SOP would require be expensed as incurred on an annual basis also be expensed as incurred in interim periods.

.163 The proposed SOP addresses accounting and disclosure issues related to determining which costs related to property, plant, and equipment should be capitalized as improvements and which should be charged to expense. The proposed SOP also addresses capitalization of indirect and overhead costs and component accounting for property, plant, and equipment. Final Statements are expected to be issued during the first half of 2003.

Exposure Draft on Liabilities and Equity

.164 The FASB has issued an exposure draft of a proposed Statement *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*. This proposed Statement would establish standards for issuers' classification in the statement of financial position of financial instruments with characteristics of liabilities, equity, or both. It would require that an issuer classify liability components and equity components of a financial instrument separately. This proposed Statement would prohibit the presentation of items between the liabilities section and the equity section of the statement of financial position.

.165 The FASB also issued an exposure draft of a proposed amendment to Concepts Statement No. 6 titled *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*. This proposed amendment would revise the definition of liabilities to also include as liabilities certain obligations that require or permit settlement by issuance of the issuer's equity shares and that do not establish an ownership relationship. The objective of the project is to improve the transparency of the accounting for financial instruments that contain characteristics of liabilities, equity, or both.

.166 Final Statements are expected to be issued during the fourth quarter of 2002.

Resource Central

Educational courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

.167 The following AICPA publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- *Audit and Accounting Guide Brokers and Dealers in Securities* (product no. 012702kk)
- *Audit Guide Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk)
- *Audit Guide Auditing Revenue in Certain Industries* (product no. 012510kk)
- *Audit and Accounting Guide Audit Sampling* (product no. 012530kk)
- *Audit Guide Analytical Procedures* (product no. 012551kk)
- *Audit Guide Service Organizations: Applying SAS No. 70, As Amended* (product no. 012772kk)
- *Practice Aid Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2002*
- *Practice Aid Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- *Practice Aid Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide* (available December 2002)
- *Audit Risk Alert E-Business Industry Developments—2002/03* [AAM section 8210]

AICPA Practice Aid Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools

.168 This Practice Aid (product no. 006600kk) provides practitioners with nonauthoritative practical guidance on auditing financial statements of FCMs, IBs, and commodity pools. Organized to complement the *Audit and Accounting Guide Brokers and Dealers in Securities*, this Practice Aid includes an overview of the commodity industry; discussions of regulatory considerations, auditing considerations, and accounting standards; and illustrative financial statements of FCMs, IBs, and commodity pools.

Audit and Accounting Manual

.169 The *Audit and Accounting Manual* (product no. 005132kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs, auditor's reports, checklists, and engagement letters, management representation letters, and confirmation letters.

AICPA reSOURCE Online: Accounting and Auditing Literature

.170 Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, *Audit and Accounting Guides* (all 23), *Audit Risk Alerts* (all 19), and *Accounting Trends & Techniques*. To subscribe to this essential online service, go to cpa2biz.com.

Educational Courses

.171 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (product no. 737082kk [VHS tape/manual] and 187082kk [video]). Whether you are in industry or public practice, this course keeps you current, informed, and shows you how to apply the most recent standards.
- *Fair Value Accounting for Hedge Transactions* (product no. 735182kk). This course helps you understand GAAP for derivatives and hedging activities. Also, you will learn how to identify effective and ineffective hedges.
- *Fraud and the Financial Statement Audit: Auditor Responsibilities Under New SAS* (product no. 731810kk [text] and 181810kk [video]; available December 31, 2002). The new fraud standard may not change your responsibilities for detecting fraud in a financial statement audit, but it will change how you meet that responsibility. Practitioners will benefit from a risk assessment approach to detecting fraud in a financial statement audit. You will learn the conceptual framework necessary to understand the characteristics of fraud.
- *Auditing for Internal Fraud* (product no. 730237kk). This course provides an auditor with the tools to identify fraud schemes. It trains CPAs to focus their analytical and substantive tests on the fraud triangle when evaluating internal controls. It also illustrates the latest in fraud prevention and detection programs implemented by industry leaders.
- *Identifying Fraudulent Financial Transactions* (product no. 730243kk). Learn to identify the red flags of fraud in financial information and to analyze a variety of fraud schemes. You will develop a framework for detecting financial statement fraud and learn about fraud schemes in revenue, inventory, liabilities, and assets.
- *Independence* (product no. 739058kk). This interactive CD-ROM course reviews the AICPA authoritative literature covering independence standards (including the SECPS independence requirements), SEC regulations on independence, and Independence Standards Board (ISB) standards.
- *SEC Reporting* (product no. 736747kk). This course helps the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.
- *E-Commerce: Controls and Audit* (product no. 731551kk). This course is a comprehensive overview of the world of e-commerce. Topics covered include internal control evaluation and audit procedures necessary for evaluating business-to-consumer and business-to-business transactions.

Online CPE

.172 The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee (\$95 for members and \$295 for nonmembers) provides unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

CPE CD-ROM

.173 *The Practitioner's Update* (product no. 738450kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

National Securities Industry Conference

.174 Each year the AICPA cosponsors with the Financial Management Division of the Securities Industry Association a National Conference on the Securities Industry that is specifically designed to update auditors and securities industry financial executives on significant accounting, legal, financial, and tax developments affecting the securities industry. Information on the conference may be obtained by calling the AICPA CPE Conference Hotline at (888) 777-7077 or visiting the AICPA Web site at www.aicpa.org.

Member Satisfaction Center

.175 To order AICPA products, receive information about AICPA activities, and find help on your membership questions call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.176 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.177 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.

Web Sites

AICPA Online and CPA2Biz

.178 AICPA Online, at www.aicpa.org, offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the Professional Standards, and CPE courses.

Other Helpful Web Sites

.179 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the "Information Sources" table at the end of this Alert.

.180 This Audit Risk Alert replaces *Securities Industry Developments—2001/02*. The *Securities 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 appreciated. You may e-mail these comments to ymishkevich@aicpa.org, or write to:

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Information Sources

<i>Organization</i>	<i>Web Site</i>
American Institute of Certified Public Accountants Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 Telephone: (888) 777-7077	www.aicpa.org
Financial Accounting Standards Board <i>Order Department:</i> 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Telephone: (203) 847-0700	www.fasb.org
Financial Crimes Enforcement Network (FinCEN)	www.treas.gov/fincen
U.S. Securities and Exchange Commission <i>Publications Unit:</i> 450 Fifth Street, NW Washington, DC 20549-0001 Telephone: (202) 942-4040 <i>Public Reference Room:</i> Telephone: (202) 942-8090 (202) 942-8092 (tty)	www.sec.gov
Securities Industry Association 120 Broadway, 35 th floor New York, NY 10271-0080 Telephone: (212) 608-1500	www.sia.com
New York Stock Exchange, Inc. 11 Wall Street New York, NY 10005 Telephone: (212) 656-3000	www.nyse.com
National Association of Securities Dealers, Inc. 1735 K Street, NW Washington, DC 20006-1500 Telephone: (202) 728-8000	www.nasd.com
The Bond Market Association 360 Madison Avenue New York, NY 10017-7111 Telephone: (646) 637-9200	www.bondmarkets.com

<i>Organization</i>	<i>Web Site</i>
Commodity Futures Trading Commission Three Lafayette Center 1155 21 st Street, NW Washington, DC 20581 Telephone: (202) 418-5000	www.cftc.gov
Futures Industry Association 2001 Pennsylvania Avenue, NW Suite 600 Washington, DC 20006 Telephone: (202) 466-5460	www.futuresindustry.org
National Futures Association 200 West Madison Street Chicago, IL 60606 Telephone: (800) 621-3570	www.nfa.futures.org

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AAM Section 8120

Not-for-Profit Organizations Industry Developments—2003

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your not-for-profit organization (NPO) audits. The information delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the not-for-profit industry, and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry information and understanding it.

Economic and Industry Developments

The State of the Economy

.03 The slow economy that has affected the nation since 2001 continues. Uncertainty permeates the financial markets and the labor market continues to worsen. The slow economy causes many consumers to agonize about their personal prospects and causes businesses to be more averse to locking into major financial commitments, investments, and significant job creation. However, the economy is well positioned for improved expansion.

.04 Fundraising has suffered under the current economic conditions. According to the GuideStar survey, nearly half of not-for-profit organizations surveyed reported a drop in donations for the first 10 months of the year, while 22 percent said contributions remained the same. Donors are concerned about the future of the economy and more skeptical about how charities operate. As the net worth of major contributors declines, so do their gifts to charities. A wide variety of charity recipients are being affected as major donors cut their donations in response to losses brought on by the most significant market downturn in 30 years. In addition, some large employers have stopped matching their employees' charitable donations.

.05 In the face of these uncertain economic times, NPOs may consider using "creative" budgeting, financing, and financial reporting techniques to avoid the appearance of deficit financial positions. They may attempt to find innovative ways to minimize the reporting of costs, maximize the reporting of contribution revenues and unrestricted net assets, and use restricted resources for unrestricted purposes. Some of these methods may be inappropriate and even fraudulent.

.06 To help you consider and address these pressures being placed on management and the audit risks that may arise, the recently issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), and its associated Implementation Guide provide extensive audit requirements and how-to guidance. Among its provisions, SAS No. 99 expands the procedures you should take to consider the potential for misstatements from fraud, including those arising from fraudulent financial

reporting. In addition, see the new appendix to Chapter 2, "General Auditing Considerations," of the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, for further guidance on SAS No. 99.

Continuing Weak Economy and Fund-Raising Challenges

.07 As endowments decline, competition for donor dollars rises, and cuts in government, corporate, and foundation funding continue, not-for-profit organizations are forced to cut back spending to preserve assets. Meanwhile the need for programs and services continues to increase, creating pressure for not-for-profits to do more with less. With fewer resources something has to give. Some NPOs may ultimately do without the resources necessary to maintain effective internal control.

.08 Proper accounting related to an organization's endowments may become a concern as negative returns and stock market declines take their toll. See the "Accounting Issues and Developments" section of this Alert for how to account for endowment losses.

The Advantages of Audit Committees

.09 Unfortunately, many NPOs operate without an audit committee. Following Enron, WorldCom, and other similar financial scandals, some occurring within the NPO arena, the audit committee has resurfaced as a vital instrument for strengthening sound financial management and fraud prevention.

.10 Audit committees can help the board of directors become aware of and put a stop to financial mismanagement within an organization. Audit committees can help the board of directors oversee the NPO's internal control and the financial reporting process. In addition, audit committees can act as a buffer between management and the auditor, as well as improving the communication between the outside auditor and the board of directors.

.11 NPOs can be particularly susceptible to fraudulent activities. NPOs operate in an atmosphere of trust with reliance on volunteers to execute crucial tasks with continual influxes of cash donations. Supervision and resources are limited, and a voluntary board of directors may lack financial expertise. NPOs may want to consider maintaining an audit committee and educating their directors and audit committee members about their roles and responsibilities.

Taxation of Internet Sales

.12 The taxation of Internet sales remains an ongoing issue. State and local governments are concerned about losing billions of revenue dollars annually because of untaxed Internet sales. Internet businesses claim that disparities in sales tax systems among the various jurisdictions make it too burdensome to administer sales tax collections.

.13 Late in 2002, a majority of states approved an interstate agreement to simplify their sales tax laws. The agreement will become effective once a certain number of states have enacted conforming legislation. In response, some of the nation's largest retailers have started voluntarily to collect taxes on their Internet sales. However, before state and local governments can enforce the taxation of Internet sales, the federal government must pass legislation permitting it. The Internet Nondiscrimination Act (Public Law [P.L.] 107-075), which expires November 1, 2003, bans new Internet access taxes and new, multiple, and discriminatory taxes on electronic commerce. Legislators have introduced bills in the 108th Congress to make the ban permanent. Surely, the states will be adding their voices to that debate.

Regulatory and Legislative Developments

.14 Auditors of NPOs may need to monitor changes in government regulations for various reasons. For example, they may be required to comply with Government Auditing Standards (GAS), also referred to as

the Yellow Book.¹ 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).² NPOs may also be affected by other federal, state, and local laws, such as laws regulating the registration of NPOs and tax laws.

.15 In the past the NPO Audit Risk Alert has discussed developments related to the following regulatory matters:

- Circular A-133 Audit Guidance Update
- Annual Compliance Supplement—Issued to help you understand the objectives, procedures, and compliance requirements of approximately 160 federal programs
 - Data Collection Form Revision and Electronic Submissions
 - Federal Grant Streamlining Program
 - Orange Book
 - Circular A-133 Audit Reviews
- Government Auditing Standards

.16 Discussions of those developments will now appear in the AICPA Audit Risk Alert *Single Audit—2003, Audits of Organizations Receiving Federal Awards: Single Audits Performed in Accordance With Office of Management Budget Circular A-133*.

Internal Revenue Service Activities

Revised Filing Requirements for 527 Political Organizations

.17 The IRS has outlined new reporting requirements that exempt many state and local political organizations from filing certain forms.

.18 The new law changes filing requirements for many political organizations that have tax-exempt status under section 527 of the Internal Revenue Code. The changes are retroactive to July 1, 2000, when the reporting requirements became mandatory.

.19 The new law:

- Exempts state and local candidate and party committees from filing Form 8871 and Form 990 (or 990-EZ);
- Exempts qualified state and local political organizations (QSLPOs) from filing Form 8872;
- Exempts political committees filing with the Federal Election Campaign (FEC) Act of 1971 from filing Form 990 (or 990-EZ);
- Exempts political organizations that are a caucus or association of state or local officials from filing Form 990 (or 990-EZ);
- Requires additional information on Form 8871 and Form 8872;
- Requires the filing of an amended Form 8871 after material changes to maintain tax-exempt status;

¹ Although *government auditing standards* primarily apply to federal assistance, some states have adopted government auditing standards.

² Instead of a single audit, under certain circumstances program-specific audits may be conducted.

- Increases reporting thresholds for certain Form 990 filers;
- Eliminates the requirement to file Form 1120-POL except when an organization has taxable income after taking the \$100 specific deduction (returning to pre-July 2000 requirements);
- Reinstates the pre-July 2000 confidentiality requirement for any Form 1120-POL filed after November 2, 2002; and
- Changes the electronic filing requirements by:
 - Requiring that Form 8871 be filed electronically (as opposed to both in writing and electronically); and
 - Requiring that any Form 8872 due after June 30, 2003, be filed electronically if the filing organization has or expects to have contributions or expenditures of more than \$50,000 during the calendar year.

.20 A more complete description of filing requirements for political organizations can be found in Fact Sheet 02-13. For further information, visit the IRS Web site at www.irs.gov/polorgs or call the IRS Tax Exempt Customer Account Service toll-free number at (877) 829-5500.

IRS Quest to Improve Form 990

.21 The IRS is attempting to alter federal Form 990 to improve its content and accountability. In the wake of numerous accounting scandals and demands for greater financial disclosure, the IRS is requesting greater financial disclosures by not-for-profits. The IRS is proposing changes to Form 990 in the following areas:

- Foreign grants
- Fundraising
- Whether an organization has an independent audit committee
- Conflict of interest policy
- Other disclosure issues, such as:
 - If the NPO should provide more information than currently required about financial relationships with “substantial” contributors, directors, officers, and other key employees.
 - Whether noncharitable exempt organizations should disclose transactions with “substantial” donors, officers, directors, trustees, and key employees, similar to the disclosures of Schedule A, Part III, Question 2.

.22 The IRS is also proposing other changes such as whether organizations should have to complete Part II of Form 990 in accordance with Statement of Position (SOP) 98-2, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Government Entities that Include Fund-Raising*. The IRS feels that it will simplify the comparisons performed regarding an organization’s fund-raising costs and produce greater uniformity. In addition, the IRS is asking whether organizations should be required to file a separate schedule detailing grants to foreign organizations and whether domestic organizations involved in foreign activities should give more specific information about money flow in those activities or about recipients in response to potential terrorist activities.

.23 Furthermore, IRS Announcement 2002-87 also brings not-for-profits up-to-date on recent changes to Form 990 including the requirement for organizations to report the gross amount raised by an outside fundraiser on Part I, line 1a since, according to the IRS, some organizations were reporting the net amount received, which allowed not-for-profits to evade reporting expenses such as fund-raising fees.

.24 Comments were due back to the IRS by January 28, 2003. As of the writing of this Alert the IRS had not finalized the possible changes yet. Readers should keep an eye out for these proposed changes.

Proposed Changes to Form 1023

.25 The IRS is proposing revisions to Form 1023, “Application for Recognition of Exemption under Section 501(c)(3) of the Internal Revenue Code,” and the instructions for Form 1023. The proposed revisions are quite extensive.

.26 Listed below are some of the more significant changes the revisions call for:

- The revised Form 1023 would require information concerning foreign activities in response to political uneasiness that some U.S. charities may have assisted in financing international terrorist activities. For example, whether the applicant was formed or has operations in a foreign country or contributes to foreign organizations the applicant must explain how control and discretion is maintained when it comes to the use of money or material given to foreign organizations.
- The proposed revisions to Form 1023 would require the applicant to include details to determine if the compensation of the officers, directors, and trustees of the applicant is reasonable. The details include each person’s qualifications, hours worked, and duties performed. A short resume for each compensated executive may be suitable according to the revised proposed instructions.
- The proposed revisions to Form 1023 would require an explanation of agreements and copies of pertinent documents to be submitted if there are any leases, contracts, or other agreements between the organization and those who control it, or with other entities, whether exempt or for-profit, over which they have “substantial influence.” Substantial influence is defined as the ability to affect decisions either as an officer, shareholder, or owner. The details to be included in the required explanation would take into account how the terms of the agreement were attained and how the conflict of interest was settled to attain an unbiased decision.
- The revised Form 1023 would include Part VIII, which is composed of 8 questions aimed at identifying potential unrelated business income. For instance, the IRS is requesting to be acquainted with the facts if the applicant performs any of the following:
 - Conducts activities over the Internet
 - Provides managerial or consulting services to other exempt organizations for a fee
 - Generates income from intellectual property (for example, patents and copyrights)
 - Operates bingo and other gaming activities
 - Conducts other activities that do not directly accomplish its charitable, educational, or religious purposes

.27 As of the writing of this Alert the IRS had not finalized the proposed revisions. Readers should keep an eye out for these proposed changes.

IRS E-File: Exempt Organizations Tax Form Schemas

.28 Preparers should be aware that the IRS now has available the proposed IRS e-file Exempt Organization Tax Schemas for the 2002 tax year. The IRS provides a zip file which consists of the schemas for Forms 990 and 990-EZ (which includes Schedules A and B), Form 1120-POL, and Form 8868. Comments were due back prior to March 24, 2003. The final release of the schemas was scheduled for March 31, 2003.

Employer Leave-Based Donation Programs

.29 As discussed in last year’s Alert some employers adopted a “leave based donation program” following the terrorist attacks of September 11, 2001. The program permitted employees to give up paid vacation, sick, or personal time off in return for the employer’s contribution of specified dollar amounts to charitable organizations.

.30 Usually, an employee who designates compensation to a charity is still considered to have received it for income tax purposes (Reg. 1.61-2 (c)). In spite of this, the IRS proclaimed that amounts donated to charity under leave-based programs before January 1, 2003, would not be included in participating employees' gross income for income tax and payroll tax purposes according to Notice 2001-69. Because no income is recognized, a participating employee would not be entitled to a contribution. Furthermore, employer payments under leave-based programs prior to January 1, 2003, were to be treated as ordinary business expenses to the employer instead of charitable contributions.

.31 Notice 2001-69 has been revoked by the IRS. Practitioners should refer to Notice 2003-1 which states that such payments made on or after January 1, 2003, will be includible in an employee's gross income and deductible only as a charitable contribution.

Revenue Rulings on Electric Cooperatives' Exemption

.32 IRC section 501(c)(12) provides for the exemption of cooperatives that receive at least 85 percent of their income from members for providing certain public utility services. Revenue Rulings 2002-54 and 2002-55 provide additional guidance on how to calculate this member income test.

Private Letter Ruling on Advertising Implications of Web Activities

.33 The IRS has taken the position that the practice of exchanging links to other Web sites or banners with other online organizations may result in taxable advertising income. The IRS will determine this based on the facts and circumstances in each case. Practitioners may refer to Private Letter Ruling (PLR) 200303062 for additional guidance on the potential tax implications of Web site links.

The Better Business Bureau Wise Giving Alliance

.34 The Better Business Bureau (BBB) Wise Giving Alliance is a charity watchdog whose objectives include assisting donors in making knowledgeable and informed giving decisions. In March 2003, it issued new charity accountability standards. These standards supersede the standards of the former National Charities Information Bureau (NCIB) and the Council of Better Business Bureaus Foundation and its Philanthropic Advisory Service (PAS) which were all merged in 2001 to create the BBB Wise Giving Alliance.

.35 The BBB Wise Giving Alliance Standards for Charitable Accountability address the following accountability issues:

- The charity's use of funds and fund-raising practices.
- Donor privacy protection.
- Charity Web site disclosures.
- The importance of spending funds in accordance with donor intentions.
- Recommendation that the charity institute an effectiveness measure to assess its performance.

.36 The BBB Wise Giving Alliance has developed the "Wise Giving Seal" which will guarantee donors that the charity operates in accordance with these thorough standards. Qualified charities will have authorization to display the seal in their solicitation material, advertisements, and other items signifying that they have met the Alliance standards. The seal is scheduled to be available this summer.

.37 An Implementation Guide for the Standards for Charitable Accountability has been developed by the Alliance. It provides detailed guidance on how each standard should be applied and their effective dates.

.38 The BBB Wise Giving Alliance Standards for Charitable Accountability and the Standards Implementation Guide can be found at www.give.org.

Sarbanes-Oxley Act and Not-for-Profits

.39 Although the Sarbanes-Oxley Act (S-O) is only applicable to public companies and their auditors, it could have a ripple effect on not-for-profit organizations. For example, in late January 2003, the New York State Attorney General's Office announced proposed requirements for nonprofits, which mimic the requirements of S-O. S-O-like provisions that could pass through to not-for-profit organizations in the future may include the certification of financial statements, increased disclosures, improved role of the audit committee, and code of conduct rules for CFOs and other senior financial officers. Readers should monitor the AICPA Web site for news about S-O and related developments.

Audit and Attestation Issues and Developments

The Internet and Internal Control Issues

.40 The Internet as a communications and direct response channel is on the rise in the not-for-profit arena. Large and small not-for-profits are using the Internet to develop strong constituent relationships to maximize fund-raising efforts. NPOs can use the Internet for marketing services, driving advocacy, recruiting volunteers, and acquiring and retaining both annual giving and major donors.

.41 NPOs are using the Internet for theme-based appeals, which explain how one's donation will be used, and volunteer-based fundraising. With annual giving and membership programs yielding poor returns of 30–50 percent of supporters from year to year, and the cost of paper-based communications rising, the Internet appears to be a promising vehicle for helping NPOs raise significant dollars. As more and more not-for-profits welcome the Internet as a powerful tool, the auditor faces new challenges.

Audit Timing and Planning

.42 NPOs with online donation transactions may automatically initiate, authorize, record, summarize, and settle transactions electronically without human intervention or physical documentation. As a result, key audit evidence in electronic form may exist only for a limited amount of time. Therefore, you will need to understand and be able to rely on information technology (IT) general controls. Computer programs may summarize transactions on a periodic basis and then purge, update, change, modify, or write over the original detail records of the transaction. Traditionally, audit procedures are performed after a client's fiscal year end. With Internet activities, however, traditional audit timing may be inadequate. One audit implication of sometimes short-term electronic evidence in audits of NPOs with online donations is that waiting until after the fiscal year end to begin auditing procedures may be too late to obtain competent sufficient evidence of controls or transactions.

.43 SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311.09), indicates that "the extent to which computer processing is used in significant accounting applications, as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures."

.44 The NPOs conducting e-philanthropy may not have hard-copy or paper evidence of transactions. Contribution statements, delivery, settlement, and authorization may be prepared and performed electronically, leaving no paper trail behind. The failure of NPOs to retain the details of transactions can create troublesome issues for the auditor who is considering whether internal control is functioning as planned. According to SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.18), as amended:

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. Therefore, the auditor should consider the time during which information exists or is available in determining the nature, timing, and extent of his or her substantive tests, and if applicable, tests of controls.

.45 If the retention of evidential matter is questionable, the auditor may want to begin audit procedures before year end. This may also drive the need for continuous auditing.

Adequate Technical Training

.46 The rapid evolution of technology has profound implications for all those affected by computer technology, including auditors. Existing NPO e-philanthropy hardware and software may need to be replaced every 18 months, or more frequently, to remain competitive. This rapid rate of technological change means that, to remain current, ongoing training in the underlying Internet technologies is requisite.

.47 Auditing through the computer and the nature of electronic evidence require that the auditor gain a more detailed understanding of the controls over transactions and records than that traditionally obtained for paper-based manual audits. You can obtain more specific technology skills through technical training courses, seminars, IT reference materials, research, and other methods.

Help Desk—The AICPA provides the following courses that are helpful to CPAs working in the environment of e-business activities: Auditing in a Paperless Society (product no. 730121kk) and E-Commerce: Controls and Audit (product no. 731550kk). How can you develop strategies for auditing around, through, and with a computer? Learn how a wide spectrum of technologies is redefining the role of auditor and auditee in these self-study courses. They are available from the AICPA Order Department at (888) 777-7077.

Using the Work of a Specialist

.48 Due to the rapid advance of technology, you may not have all the skills necessary to audit online activities. Until you and your staff have the technical skills needed to audit NPO e-philanthropy of online donations, you may need to engage IT audit specialists to perform certain procedures. Qualified IT specialists are sometimes available from another part of the firm, such as the consulting division or the internal IT support staff. If not, you may have to go outside your own organization to obtain qualified specialists. Engaging a specialist for gaining an understanding of internal controls, tests of controls, substantive tests, and analytical procedures requires awareness of guidelines available in the authoritative literature. According to SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336.06), specialized assistance is advisable for auditors who:

... may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skills or knowledge and in the auditor's judgment require using the work of a specialist to obtain competent evidential matter.

.49 The use of an outside specialist³ in an Internet context does not absolve the auditor from a certain level of understanding about computers. Audit planning comes into play because of the lead time necessary to contract for a specialist's services and the time required for the auditor to obtain the minimum technological knowledge necessary to supervise the specialist. According to SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311.10):

If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who may be either on the auditor's staff or an outside professional. If the use of such a professional is planned, the auditor should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditor's objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other

³ Note that SAS No. 73 does not apply to specialists who are employed by the firm and are part of the engagement team. SAS No. 73 indicates that the auditor uses the work of the specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions. The specialist does not, however, perform the substantive tests or analytical procedures.

planned audit procedures. The auditor's responsibilities with respect to using such a professional are equivalent to those for other assistants.

Internal Control as It Affects Audit Evidential Matter

.50 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance on the independent auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS). For traditional businesses, the auditor's consideration of internal control typically involves updating prior-year checklists, questionnaires, and procedural narratives. Using a traditional audit approach for e-philanthropy NPO clients would be insufficient because, in the e-philanthropy environment, almost all of the evidence of transactions is electronic. Critical records may consist of e-mail, database records, electronic documents, spreadsheets, and server logs. In addition, e-philanthropy transactions are subject to intentional and unintentional alteration and manipulation at many points between transaction initiation and summarization in the financial statements. Because NPO e-philanthropy segments generally lack much of the paper evidence found in audits of traditional businesses, your approach to understanding internal controls when planning the e-philanthropy audit and determining the nature and extent of substantive tests should take this into account.

.51 SAS No. 55, as amended, provides guidance to auditors about the effect of IT on internal control and on the auditor's understanding of internal control and assessment of control risk. In some circumstances, auditors may need to perform tests of controls to perform an effective audit.

The Importance of Software Controls

.52 As noted earlier, technology continues to evolve rapidly. Most server software is constantly upgraded, modified, and configured with components from different vendors. Often, when software is upgraded, previous control settings are lost, with no warning to managers. If procedures are performed before year end, you have the additional responsibility to consider whether there are frequent and significant changes being made to the NPO systems that might affect the remainder of the period. According to SAS No. 55 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.99):

When the auditor obtains evidential matter about the design or operation of controls during an interim period, he or she should determine what additional evidential matter should be obtained for the remaining period . . . The auditor should obtain evidential matter about the nature and extent of any significant changes in internal control, including its policies, procedures, and personnel, that occur subsequent to the interim period.

.53 Access is another issue to consider when testing controls over online activities. To test controls, auditors need access to networks, servers, and databases on which entities store their accounting records. Information technology managers may be reluctant to grant auditors the level of access they need, preferring, instead, to provide lengthy printouts, files on diskettes, or files as e-mail attachments. Access to copies of records in these forms is insufficient. Auditors should have full read-access rights to all system and database security settings and tables as well as the underlying electronic accounting records to gain a sufficient understanding of controls and to perform substantive tests.

.54 E-philanthropy software should include controls to prevent the repudiation or alteration of records that initiate transactions. Such controls might include digital signatures or server certificates that authenticate the parties to the transaction, as well as traditional edit and validation controls. Electronic (digital) signatures reduce the likelihood of the parties claiming that they never initiated the transaction or that the record of the terms of the transaction has been altered. Without server certificates, an initiator of a transaction has no assurance that it is dealing with the intended party's computer. Without digital signatures and server certificates, it may be difficult to determine that transactions are neither fictitious nor fraudulent.

The Importance of Monitoring

.55 A key control in a system of internal control is monitoring. Routers, firewalls, Web servers, e-mail servers, databases, and operating systems all have the ability to log traffic and specific security events. Properly implemented and controlled logs can provide some evidence that a transaction occurred and that the transaction record has not been altered. Independent audits of the controls carried out at third parties, along with the use of digital certificates, encryption, access controls, and logging, help provide evidence for the auditor regarding the integrity of recorded transactions.

Key Controls in an Electronic Environment

.56 To reduce the chance of an auditor relying on evidence that lacks credibility, he or she should understand the key controls over validity, completeness, and integrity. In the electronic environment, these typically include the following:

.57 *Segregation of Duties.* Different employees should perform the duties of security administration, security monitoring, system administration, application maintenance, software development, and daily accounting operations.

.58 *Authorization.* User access to networks, systems, servers, services, programs, data, and records should be authorized based on the organization's security policy and documented.

.59 *Authentication.* The identity of authorized users should be established by the use of logon IDs, hard-to-guess and hard-to-crack passwords, and, where appropriate, smart cards.

.60 *Access Limitations.* Authorized users should be granted access to networks and application systems only after they authenticate themselves, and their access rights should be commensurate with their job responsibilities.

.61 *Activity Logging.* Logging should be enabled on all routers, firewalls, servers, databases, and operating systems. The logs should be protected from tampering and alteration and should be retained.

.62 *Independent Monitoring.* Employees independent of the IT department should monitor the activity logs on a frequent enough basis to detect suspicious, unusual, and unauthorized activity. Due to integration of e-philanthropy as discussed above, it should be independent of operations including IT.

.63 *Methods of Error Correction.* Software should have controlled rollback procedures so records are not purged or lost when servers crash and programs abort. Controls preventing changes to historical records should be in place so errors are corrected by entries made by the accounting department. Programmers and other IT personnel should not be able to make changes to actual accounting records.

.64 *Backup Procedures.* Grandfather, father, and son daily backup procedures should be performed, as well as weekly, monthly, quarterly, and annual backups. All files that include the details of transactions should be included in the backup. With the advice of legal counsel, the key user or owner of the data should establish retention schedules to satisfy legal and regulatory requirements. The backup media should have clear exterior identification, and there should be an offline log and inventory of what was backed up, when, by whom, and where stored. Backups should be stored in a safe location off-site and tested periodically by the key user of the data.

.65 *Disaster Recovery.* The nature of online services often requires that systems be capable of operating 24 hours a day, seven days a week. Even short periods of outage may mean significant financial loss to some NPOs. There should be a written plan on how systems will roll over to alternative systems should the data center be destroyed or rendered inoperable. The plan should periodically be tested.

.66 The strength of controls in an electronic environment is like a chain, where strength is determined by the weakest link. You should consider whether any weak links are present and, if so, consider the need to adjust your risk assessment and substantive tests accordingly.

Reports From Service Organizations

.67 Many clients use an Internet service provider (ISP) or application service provider (ASP) to host their Web site, including the databases used to initially record contributions and credit card receivables. In a number of cases, ISP/ASP servers provide fulfillment by allowing users to immediately download their contribution after credit approval for electronic documents. For clients that use outsourced services, auditors can sometimes obtain a report on controls from the service organization. According to SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324.24), as amended, the report would be either (1) reports on controls placed in operation, or (2) reports on controls placed in operation and tests of operating effectiveness.

Fraudulent Financial Reporting

.68 The recent highly publicized instances of fraudulent financial reporting serve as reminders to auditors of the need to remain alert to possible instances of fraudulent activity and to maintain an appropriate attitude of professional skepticism. Most fraud cases involve management fraud or deliberate deceit by management in working with their auditors.

.69 Not-for-profit organizations face mounting pressure to meet the expectations of “watch dog” groups that monitor the use of their resources. Moreover, the image of the not-for-profit organization has a significant effect on a donor’s willingness to contribute. Negative press can considerably decrease future contributions, the availability of volunteers, and public goodwill. Consequently, management of the not-for-profit organization may be subject to unusual pressure to report certain financial results. Such pressure could be a motivation for management to engage in fraudulent financial reporting. Also, significant fraud risk may exist not as an overstatement of operations, but rather as an intentional understatement of operations so that donors perceive a need to continue to give.

.70 Additional factors that not-for-profits confront are the use of ample numbers of volunteer workers who may not be properly trained or supervised; pressure to restrain managerial expenses, resulting in inadequate internal control; scores of 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 dependence on board members to help achieve needed goals and services, resulting in related-party transactions.

Auditing Guidance and Audit Issues

.71 Some of the more common audit issues identified in fraudulent financial reporting include:

1. A willingness by the auditor to accept management’s representations without corroboration
2. Allowing the client to unjustifiably influence the scope of auditing procedures
3. Failure to identify risky situations, or ignoring identified audit risks by not applying professional skepticism and revising auditing procedures appropriately

.72 Auditors need to consider such issues as part of their assessment of the risk of material misstatement due to fraud, as required by SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

.73 SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02), 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.” That Statement establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit conducted in accordance with GAAS. Auditors also need to consider SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), and SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), for additional guidance on the consideration of fraud and illegal acts. Also, auditors should refer to SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230), for additional guidance on professional skepticism. Because of the characteristics of fraud, the auditor’s exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.

.74 Among other things, SAS No. 99:

- Describes the characteristics of fraud. The more the auditor knows about the nature of fraud, the better he or she will be equipped to identify risk factors, assess the risk of material misstatement due to fraud, and develop an appropriate audit response.
- Discusses the importance of exercising professional skepticism when considering the possibility that a material misstatement due to fraud could be present.
- Requires a discussion among engagement personnel regarding the risks of material misstatement due to fraud as part of planning the audit. The discussion among the audit team members should consider how and where the not-for-profit’s financial statements might be susceptible to material misstatement due to fraud and reinforce the importance of adopting an appropriate mindset of professional skepticism.
- Requires the auditor to gather information necessary to identify risks of material misstatements due to fraud by (1) inquiring of management and others within the NPO about the risks of fraud, (2) considering the results of analytical procedures performed in planning the audit, (3) considering fraud risk factors, and (4) considering certain other information.
- Requires the auditor to use the information gathered to identify risks that may result in a material misstatement due to fraud.
- Requires the auditor to evaluate the NPO’s programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation.
- Provides guidance on how the auditor responds to the results of the risk assessment by emphasizing that the auditor’s response should involve the application of professional skepticism when gathering and evaluating audit evidence. It also requires the auditor to respond to the results in three ways (AU sec. 316.50–.67).
- Requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the assessment.
- Provides guidance regarding the auditor’s communications about fraud to management, the audit committee, and others.
- Provides examples of fraud risk factors that, if present, might indicate the presence of fraud.
- Requires the auditor to document evidence of the performance of the fraud risk assessment, including risk factors identified as being present and the auditor’s response to those risk factors.

Fraud Risk Factors

.75 The following are a few of the risk factors discussed in SAS No. 99 that may exist at a not-for-profit organization:

- 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

.76 Regardless of when the auditor discovers fraud risk factors or other conditions related to the fraud risk assessment, the auditor should consider their effect on auditing procedures. The auditor should document the risk factors identified, as well as the auditor's response to the risk factors. The fraud risk factors and other conditions identified may cause the auditor to believe that the planned audit procedures are not sufficient to provide reasonable assurance that the financial statements are free from material misstatement. Accordingly, auditing procedures should be planned and performed to specifically address the identified risks.

Professional Skepticism

.77 Very importantly, auditors must maintain an appropriate attitude of professional skepticism. This means neither assuming that management is dishonest nor assuming unquestioned honesty; obtaining corroborating evidence for management representations; considering whether misstatements may be the result of fraud; and appropriately designing and performing auditing procedures to address fraud risk factors. The application of professional skepticism in response to the auditor's assessment of the risk of material misstatement due to fraud might include the following:

1. Increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions
2. Increased recognition of the need to corroborate management explanations or representations concerning material matters such as further analytical procedures, examination of documentation, or discussions with others within or outside the organization
3. The assignment of more senior or experienced personnel to plan and perform certain auditing procedures

Help Desk—For further information on fraud refer to the AICPA Practice Aid *Fraud Detection in a GAAS Audit*—SAS No. 99 Implementation Guide (product no. 006613kk).

Auditing Contributions Receivable

.78 Although contributions receivable are not required to be confirmed under SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), auditors may nevertheless decide to request confirmation of contributions receivable. Auditors deciding to request confirmation of contributions receivable should consider requesting such confirmations more than just in the first year in situations where the contributions are large pledges and multi-year gifts. (Auditors should refer to SAS No. 67, for guidance about the confirmation process.) Many auditors confirm these types of contributions only in the first year and never again. Thus situations can arise where the contribution is not being properly reflected in subsequent years and the confirmation process would have revealed that. For example, an extension of the repayment terms may result in changes in the estimated fair value which can then lead to improper valuation if not reflected in the accounting records.

.79 Confirming recorded promises to give (contributions receivable) may help the auditor obtain additional evidence regarding the existence of the promise to give, the existence or absence of restrictions and conditions, and the periods over which the promises to give become due. This will provide additional evidence about recognition initially and for subsequent measurement of the contribution receivable. Remember that the fair value of contributions arising from unconditional promises to give cash and noncash assets may change because of (1) changes in the quantity or nature of assets expected to be received (such as in the amounts of future cash flows), (2) changes on the timing of assets expected to be received, and (3) changes in the expected fair value of underlying noncash assets. The confirmation process may help auditors address the financial statement assertions regarding contribution receivables.

.80 Initial confirms are used principally to provide evidence about the existence/occurrence assertion. Subsequent confirms can be used as an additional audit consideration to address completeness, valuation, and presentation and disclosure. In other words, subsequent confirmation procedures may help address changes that have occurred in the contribution receivable, whether collectibility is an issue, if any changes in the fair value of the underlying asset have occurred, and if amounts are appropriately reported in the financial statements. Readers should refer to the "Accounting Issues and Developments" section of this Alert for guidance on accounting for contribution receivables.

Common Engagement Deficiencies

.81 Following are some deficiencies commonly noted on not-for-profit engagements during recent peer reviews and AICPA Professional Ethics Division investigations of CPA firms. This list continues to include some of the deficiencies identified in the past, indicating continuing problems with the same matters. You should consider reviewing your firm's policies and procedures to see whether your not-for-profit engagements also might have these kinds of issues.

- Failure to identify a voluntary health and welfare organization as such.
- Incorrect classification of contributions as unrestricted, temporarily restricted, or permanently restricted.
- Failure to present a statement of cash flows (as required by Financial Accounting Standards Board [FASB] Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations*).
- Inadequate audit procedures to support the statement of functional expenses.
- Improper accounting for restricted funds.
- Inadequate format, titles, and presentation of financial statements.
- Failure to obtain sufficient evidence to substantiate the value of noncash gifts.

Auditor Association With Municipal Securities Disclosure Documents

.82 The new Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*, expands its discussion about situations in which an auditor becomes associated with an official statement or other offering document for the issuance of municipal securities and, thus, when the auditor should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), as amended by SAS No. 98, *Omnibus Statement on Auditing Standards—2002*. Paragraph 16.06 in this Guide states that the auditor becomes associated with the official statement in any of the following situations:

- Assisting in preparing the financial information included in the official statement.
- Reviewing a draft of the official statement at the government's request.
- Manually signing the independent auditor's report included in the official statement.
- Providing a revised independent auditor's report for inclusion in a specific official statement.

- Issuing a comfort letter, the letter described in SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1, AU sec. 634.09), as amended, or an attestation engagement report in lieu of a comfort or similar letter on information included in the official statement.
- Providing written agreement for the use of the independent auditor's report in the official statement.
- Issuing a report on an attestation engagement relating to the debt offering. (The new Guide includes a discussion on attestation engagements related to the issuance of municipal securities in paragraph 16.20).

.83 Additional information about these seven situations is included in the new Guide. As discussed in paragraphs 16.07 and 16.10 of the Guide, if the auditor is associated with an official statement the guidance in SAS No. 8 provides that the auditor has no obligation to perform any procedures to corroborate other information contained in those documents. However, the auditor should read the other information and consider whether that information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. SAS No. 8 (AICPA, *Professional Standards*, vol. 1, AU sec. 550.04–.06), provides guidance if the auditor concludes there is a material inconsistency or a material misstatement of fact that is not a material inconsistency. Although an auditor is not required to become associated with a government's official statements except in the situations described in paragraph 16.06 of the Guide, some auditors include a provision in the engagement letter requiring the government to obtain permission from the auditor before using the independent auditor's report in the official statement. Such a provision establishes a requirement that the auditor become associated with the government's official statements when the government requests the required permission from the auditor.

.84 In a November 1994 amendment to rule 15c2-12, the SEC required municipal securities dealers to contract with issuers of municipal bonds for them to provide continuing disclosures at certain times for the life of the bond issue. (See the related discussion "Municipal Securities Disclosures" in the "Accounting Issues and Developments" section of this Alert). Continuing disclosures, or secondary market disclosure requirements, are made by issuers providing to nationally recognized municipal securities information repositories and state information repositories annual continuing disclosure documents and material events notices. Material events notices are required for 11 specific events, such as principal and interest payment delinquencies and nonpayment-related defaults. Material event notices are provided through a press release or other written notification on an "as needed" basis and do not involve financial statements.

.85 Paragraph 16.09 in the new Audit and Accounting Guide *Audits of State and Local Governments* (GASB 34 Edition), states that the auditor is not required to participate in or undertake any procedures with respect to a government's continuing disclosure documents, even though they may include audited financial statements. A government's continuing disclosures are not required to be submitted to or disseminated from the distributing organizations as a single document. Thus, an auditor's association with other information encompassed by such disclosures cannot be clearly established. Therefore, the provisions of SAS No. 8 do not apply to documents that contain those disclosures. Any attention the auditor devotes to other information included with audited financial statements in continuing disclosure documents at the government's request should be considered a consulting engagement under the provisions of the AICPA Statement on Standards for Consulting Services No. 1, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*, vol. 2, CS sec. 100).

SOP 98-3, Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards, Converted to a Guide

.86 Some auditors have been unaware that SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, is updated annually for conforming changes, including changes resulting from last year's two Yellow Book amendments. To better serve practitioners and increase awareness

of the changes made every year to the guidance, SOP 98-3 has been converted to an audit guide and will be available in the third quarter of 2003. Auditors should consider obtaining the newly issued guide inasmuch as significant changes have been made to the guidance since SOP 98-3 was issued. The newly issued guide will continue to be revised annually to keep it up-to-date for changes in the Yellow Book, single audit literature and processes, and Statements on Auditing Standards.

Accounting Issues and Developments

Split Interest Agreements

.87 Some NPOs have entered into split interest agreements that promised beneficiaries payout rates that are higher than the rates the NPOs are currently earning on their investments. For example, in the 1990s, NPOs may have entered into agreements promising to pay returns of 8 percent to 10 percent, and now the NPOs are earning 2 percent to 3 percent (or less) on the underlying investments. The current market conditions have implications for both accounting and donor relations.

.88 NPOs that did not lock-in returns on investments adequate to fund those obligations to third-party beneficiaries (that is, equal to or exceeding the discount rate used to compute the fair value of the liability) may face the following issues:

- For charitable gift annuities held as general assets and obligations of the NPO, the NPO is in effect incurring economic losses each period in which the interest rate earned is below the initial discount rate. Those losses are not reflected in the financial statements, however, because the interest rate used to discount the liability to the donor is not adjusted to reflect current market conditions. NPOs should consider disclosing such circumstances.
- For annuity trust agreements, continuing to pay a rate greater than is earned raises the possibility that trust assets may be depleted to the extent that at a future date there will be insufficient assets to fund obligations to income beneficiaries. In such circumstances, the trust may eventually have to cease making the payments. Publicity about such conditions and risks, which may not have been clarified in the solicitation or afterwards, could adversely affect the NPO's ability to raise contributions in the future. NPOs should consider disclosing such circumstances. The concern about depleting assets to the extent that payments cease would not apply to typical pooled-life income funds because beneficiaries receive only the income earned on the trust. It also would not apply to unitrusts because the payment amount changes annually as the fair value of the unitrust assets changes.

Even though unitrusts and pooled-life income funds may not be depleted to the extent that payments cease, the current market conditions may have significantly reduced the income of pooled income funds or the fair value of assets in charitable unitrusts. As a result, the payments to beneficiaries also may have been significantly reduced. NPOs that do not inform beneficiaries about the impact of market conditions on the amount of their distributions before the decreases in payments occur may face problems of donor alienation. The effects of potential donor alienation on future gifts should be considered.

Classification of Net Assets in Consolidation

.89 When the net assets of two or more NPOs are combined into a single set of financial statements—for example as a beneficiary and financially interrelated recipient organization, as parent and subsidiary, or as brother and sister under common control, special consideration should be given to the classification of net assets. To illustrate, assume a parent NPO has NPO subsidiaries. In the subsidiary's separately issued financial statements, certain net assets may be reported as unrestricted because the use of the contributed asset is no more specific than broad limits resulting from the nature of the organization, the environment in which it operates, and the purposes specified in the organization's articles of corporations or bylaws (or comparable documents for an unincorporated association). In the consolidated financial statements, however,

the unrestricted net assets of the subsidiary arising from contributions (or investment income on donor-restricted endowment funds) should be reported as temporarily restricted net assets if in fact their use is more specific than broad limits resulting from the nature of the parent organization, the environment in which it operates, and so on.

.90 Example: A membership association (Parent) has an educational subsidiary whose mission is to provide scholarships. Donors make unrestricted contributions to the educational subsidiary with the intent that the subsidiary use the contributions to support its mission, including granting scholarships, and incurring fund-raising and general and administrative expenses. The gifts to the educational subsidiary are therefore classified as increases in unrestricted net assets, but if the educational subsidiary's financial statements are consolidated with the membership association (Parent), the classification of the net assets of the subsidiary should be adjusted to reflect that they are donor-restricted net assets from the perspective of the Parent's consolidated financial statements. The unrestricted net assets of the educational subsidiary resulting from contributions (or investment income on donor-restricted endowment funds) should therefore be reported as temporarily restricted net assets in the Parent's consolidated financial statements.

.91 In summary, if the net assets or results of operations of an organization with a narrow mission are combined (via consolidation, combination, or equity method accounting) with the net assets of an organization with a broader mission, the classification of the net assets of the organization with the narrower mission may need to be adjusted to reflect donor-imposed restrictions if the source of the net assets was contributions (or investment income on donor-restricted endowment funds). The classification of the unrestricted net assets of the organization with the narrower mission would not be adjusted if those net assets arose from exchange transactions, such as fees or ticket sales.

Municipal Securities Disclosures

.92 Issuers of municipal bonds, including not-for-profit health care organizations that are conduit issuers of municipal bonds, are exempt from the registration and reporting requirements of the federal securities laws. However, they are not exempt from antifraud provisions of the federal securities laws, which forbid making misleading statements in, or omitting material facts from, disclosures made in official statements and annual financial filings and other statements speaking to the market. Briefly, the antifraud provisions apply to a municipal issuer whenever it releases information to the public that is reasonably expected to reach investors and the trading markets. If a statement is made reaching markets or investors, the antifraud provisions apply, regardless of whether the statement is made on paper or delivered electronically. The SEC Interpretive Release *Use of Electronic Media* provides interpretive guidance to corporate and municipal issuers on how securities fraud laws apply to such matters as the electronic delivery of documents and electronic disclosure.

.93 The principal sources of SEC guidance on the operation of the municipal disclosures framework and application of the antifraud provisions are (1) SEC releases, including the March 1994 SEC Interpretive Release No. 34-33741, *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*, and SEC Release No. 34-34961, *Secondary Market Disclosure*, an amendment to Rule 15c2-12 issued in November 1994; and (2) SEC enforcement actions in the municipal sector involving the antifraud provisions. As of writing this Alert, there were no recent releases from the SEC relating to the municipal securities market.

.94 For additional information on the SEC and municipal securities developments, see the SEC Web site, www.sec.gov. This site includes a page providing a shortcut to information on the SEC Web site for municipal issuers and other participants in the municipal securities markets.

.95 See the related discussion "Auditor Association With Municipal Securities Disclosure Documents" in the "Audit and Attestation Issues and Developments" section of this Alert.

Losses on the Investments of Donor-Restricted Endowment Funds

.96 Many not-for-profit organizations have endowment funds that are commingled and invested as a pool. The funds combined in that pool are usually a mix of true endowments, term endowments, and quasi-endowment funds (also sometimes called funds functioning as endowment.) Questions have arisen as to how the losses on the investments of the pool should be classified.

.97 Paragraphs 11, 12, and 15(d) of FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, state that:

A donor's stipulation that requires a gift to be invested in perpetuity or for a specified term creates a donor-restricted endowment fund. Unless gains and losses are temporarily or permanently restricted by a donor's explicit stipulation or by a law that extends a donor's restriction to them, gains and losses on investments are changes in unrestricted net assets. For example, if a donor states that a specific investment security must be held in perpetuity, the gains and losses on that security are subject to that same permanent restriction unless the donor specifies otherwise. However, if a donor allows the organization to choose suitable investments, the gains are not permanently restricted unless the donor or the law requires an amount be retained permanently. Instead, those gains are unrestricted if the investment income is unrestricted or are temporarily restricted if the investment income is temporarily restricted by the donor.

In the absence of donor stipulations or law to the contrary, losses on the investments of a donor restricted endowment fund shall reduce temporarily restricted net assets to the extent that donor-imposed temporary restrictions on net appreciation of the fund have not been met before the loss occurs. Any remaining loss shall reduce unrestricted net assets.

For each period in which a statement of financial position is presented, a not-for-profit organization shall disclose the aggregate amount of the deficiencies for all donor-restricted endowment funds for which the fair value of the assets at the reporting date is less than the level required by donor stipulations or law.

.98 To determine how the losses on an investment pool should be classified, an organization should look to the restrictions on the individual funds that constitute the pool rather than to the aggregate of all investments in the pool. The loss on the pool assets is unitized and allocated to each individual fund. Then the donor restrictions on the net assets of the individual funds (or the lack of donor restrictions) determine the classification of that fund's loss.

.99 *Example:* Assume an organization has pooled the investments of three donor-restricted endowment funds and one quasi-endowment fund. The quasi-endowment fund was established by the governing board using unrestricted net assets. The investments in the pool have a fair value of \$1,575,000, and there are 1,575 units with a value of \$1,000 each.

.100 The first donor-restricted endowment fund (Fund 1) is very old—it owns 1,000 units with a fair value of \$1,000,000—\$100,000 of permanently restricted net assets, \$350,000 of temporarily restricted net assets, and \$550,000 of unrestricted net assets. The second donor-restricted endowment fund (Fund 2) is just a few years old. It owns 50 units with a fair value of \$50,000—\$40,000 of permanently restricted net assets, \$2,000 of temporarily restricted net assets, and \$8,000 of unrestricted net assets. The third donor-restricted endowment fund (Fund 3) is new—it owns 25 units with a fair value of \$25,000—\$25,000 of permanently restricted net assets. The gift agreements that established the donor-restricted endowment funds do not have stipulations about what should be done if the fund suffers a loss. The quasi-endowment fund (Fund 4) owns 500 units with a fair value of \$500,000, all of which is unrestricted.

.101 The market value of the investments of the pool falls to \$1,417,500, or a loss of \$157,500. How should that loss be classified?

.102 Each unit is now worth \$900 (\$1,417,500/1,575), for a loss of \$100 per unit. As a result, Fund 1 has a fair value of \$900,000 and a loss of \$100,000. Fund 1's loss of \$100,000 reduces temporarily restricted net assets by \$100,000 because Fund 1 had temporarily restricted net assets of \$350,000 before the loss occurred.

.103 Fund 2 has a fair value of \$45,000 and a loss of \$5,000. Fund 2's loss reduces temporarily restricted net assets by \$2,000 and unrestricted net assets by \$3,000. The loss reduces the net appreciation of the fund from prior years that were classified as temporarily restricted net assets until those net assets are entirely depleted, then it reduces the net appreciation that was classified as unrestricted net assets.

.104 Fund 3 has a fair value of \$22,500 and a loss of \$2,500. Fund 3's loss reduces unrestricted net assets by \$2,500 because the fund had no temporarily restricted net assets. Although the fund has no net appreciation from prior years, the loss does not reduce the permanently restricted net assets. FASB Statement No. 124 requires losses to be classified as decreases in unrestricted net assets unless there is a donor's explicit stipulation or a law that extends a donor's stipulation to the loss.

.105 Fund 4 has a fair value of \$450,000 and a loss of \$50,000. Fund 4's loss of \$50,000 reduces unrestricted net assets because the entire fund was free of donor restrictions.

.106 Thus, the \$157,500 loss on the investments of the pool is classified as a decrease in temporarily restricted net assets of \$102,000 and a decrease in unrestricted net assets of \$55,500. The temporarily restricted net assets of Fund 1 cannot be used to absorb the losses in Funds 2, 3, or 4.

.107 The organization should disclose that the aggregate deficiency for all donor-restricted endowment funds is \$2,500, which is the amount by which the fair value of Fund 3's assets (\$22,500) is less than the amount it should maintain permanently (\$25,000). Funds 1 and 2 have values greater than the amount they are required to keep permanently.

.108 If the market recovers and the fair value of the investments increases after the end of the fiscal year, paragraph 13 of FASB Statement No. 124 says:

If losses reduce the assets of a donor-restricted endowment fund below the level required by the donor stipulations or law,⁴ gains that restore the fair value of the assets of the endowment fund to the required level shall be classified as increases in unrestricted net assets.

⁴ Donors that create endowment funds can require that their gifts be invested in perpetuity or for a specified term. Some donors may require that a portion of income, gains, or both be added to the gift and invested subject to similar restrictions. It is generally understood that at least the amount of the original gift(s) and any required accumulations is not expendable, although the value of the investments purchased may occasionally fall below that amount. Future appreciation of the investments generally restores the value to the required level. In states that have enacted its provisions, the Uniform Management of Institutions Funds Act describes "historic dollar value" as the amount that is not expendable.

.109 Because the fair value of Fund 3 is \$2,500 less than the amount that should be maintained permanently, the first \$2,500 of gains earned by Fund 3 are classified as an increase in unrestricted net assets. Any additional gains are classified as permanently restricted, temporarily restricted, or unrestricted in accordance with the donor stipulations.

.110 Auditors should test the allocation of losses to individual endowment funds. The classification of the loss within the individual endowment fund depends on the amount of net appreciation of the fund in prior years and the classification of that net appreciation in accordance with explicit donor restrictions or a law

that extends the donor restrictions to the net appreciation. (In many states, the Uniform Management of Institutional Funds Act, as adopted, provides the relevant law.) Auditors should review gift instruments and state law to determine the amount of the fund that should be permanently retained and consider whether losses, if any, reduce the fair value of the assets of the fund to an amount that is less than that permanent amount. A loss first reduces the temporarily restricted net appreciation of the fund until it is entirely depleted, then it reduces the unrestricted net appreciation of the fund. If there is no net appreciation in the fund from prior years or if the loss exceeds the net appreciation from prior years, the loss reduces unrestricted net assets. The deficits for all donor-restricted endowment funds for which the fair value of the assets at the reporting date is less than the level required by donor stipulations or law should be disclosed by the organization in its financial statements.

.111 The classification of losses on the investments of a pool is complex and time-consuming. Both organizations and their auditors should allow adequate time to perform necessary procedures properly.

Accounting for Cash Contributions Receivable

.112 Auditors should be reminded that contributions revenue should be measured at the fair value (using quoted market prices if available) of the assets or services received or promised or at the fair value of liabilities satisfied. But, net realizable value may be used when the contributions arise from unconditional promises to give and are expected to be collected within one year of the financial statement date.

.113 The fair value of contributions arising from unconditional promises to give cash should be determined based on the present value of the estimated future cash flows. For example, initial recognition of an unconditional promise to give cash of \$1,000 that is expected to be collected in five years should be measured and reported as follows. First the NPO should determine the estimated future cash flows from the promise to give cash. The not-for-profit should consider when the receivable is expected to be collected, the creditworthiness of the other parties, the organization's past collection history and its policies in connection with the enforcement of promises to give, and other factors concerning the receivable's collectibility in determining the estimated future cash flows. In this case we will use \$700 as the estimated future cash flows from the promise. (Note that the organization does not report bad debt expense of \$300—the difference between the \$1,000 promised and the \$700 expected to be collected.) Then the NPO should determine the present value of the estimated future cash flows which should be measured using a risk-free rate of return appropriate for the expected term of the promise to give. The amount to be discounted is considered to be free from credit risk since the donor's credit rating and other factors affecting the donor's ability to honor the promise to give would be considered already in determining the estimated future cash flows of unconditional promises to give cash. In conformity with paragraph 12 of Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*, the discount rate should be determined at the time the unconditional promise to give is initially recognized and should not be revised subsequently.

.114 Some donors extend payment terms longer than what was called for in original gifts. More often than not, the NPO has not updated the accounting or calculations for discounted future amounts to reflect longer terms or, in extreme cases, revising uncollectible amounts. Auditors should consider subsequent measurement of unconditional promises to give cash and noncash assets because the fair value of the contributions may change if the following conditions occur: (1) changes in the quantity or nature of assets expected to be received, such as changes in the amounts of future cash flows, and (2) changes in the timing of assets expected to be received. Readers should refer to footnote 25 of paragraph 5.70 of the Audit and Accounting Guide *Not-for-Profit Organizations*, since the Guide does not address changes in the timing of assets expected to be received. Since in the current environment we are more concerned with losses we will discuss only losses here. Decreases due to changes in the quantity or nature of assets expected to be received should be recognized in the period(s) in which the expectation changes. Those decreases should be reported as expenses or losses (bad debt) in the net assets class in which the net assets are represented. Decreases in contributions because of changes in the amounts of assets expected to be received should be reported as losses if they are decreases in temporarily restricted net assets or permanently restricted net assets.

Functional Classifications of the Costs of Soliciting Exchange Transactions

.115 Management and general activities are defined as those activities that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization's existence. Among other activities, they include soliciting revenue from exchange transactions, such as government contracts and related administrative activities. Costs of soliciting funds other than contributions, including exchange transactions (whether program-related or not), should be classified as management and general expenses.

Accounting for Fund-Raising Costs

.116 Fund-raising costs, including the cost of special fund-raising events, are incurred to induce donors to make contributions to an organization and should be expensed as incurred. Incurred is defined as when the item or service has been received. Fund-raising costs incurred in one period, such as those made to obtain bequests, compile a mailing list of prospective contributors, or solicit contributions in a direct-response activity, may result in contributions that will be received in future periods but still should be expensed as incurred. For example, fund-raising materials, such as brochures, sitting in a warehouse should be expensed even though they have not yet been mailed. Also included as an expense when incurred are any salaries or consulting fees to develop the brochures.

Derivative Accounting and Split Interest Agreements

.117 Under FASB Derivatives Implementation Group (DIG) Issue B35, many split interest agreements will require bifurcation and derivative accounting. For lead interest agreements in particular, in circumstances in which the NPO has a liability to a beneficiary, even if the lead interest is a fixed payment, as long as the liability is variable and the agreement is period certain, it will qualify as a derivative. This is because the liability to the third party will usually vary based on the fair value of investments.

Required Detailed Disclosures Concerning Contributions of Services

.118 As a reminder, the following disclosures should be included in the notes to the financial statements concerning contributions of services received during the period: (1) the nature and extent of contributed services received by the organization; (2) a description of the programs or activities for which the services were used; and (3) the amount of contributed services recognized during the period. NPOs are also encouraged, if practicable, to report in the notes to the financial statements the fair value of contributed services received but not recognized.

Lapsing of Restrictions in Circumstances in Which Both Time and Purpose Restrictions Exist

.119 In circumstances in which both donor-imposed purpose and donor-imposed time restrictions exist, expenditures meeting the purpose restriction should be made simultaneously with or after the time restriction has expired in order to satisfy both the purpose and time restrictions and result in a reclassification of net assets from temporarily restricted to unrestricted. In other words, donor-imposed time restrictions, if any, must be met before expenditures can result in purpose restrictions being met. Paragraph 150 of FASB Statement No. 116, *Accounting for Contributions Received and Contributions Made*, provides that "the [FASB] believes that it is reasonable to assume that by specifying future payment dates donors indicate that their gift is to support activities in each period in which a payment is scheduled". The AICPA staff is considering developing a Technical Practice Aid (TPA) to address this issue. Readers may refer to FASB Statement No. 116, footnote 5 and paragraph 150, for additional guidance.

TPA 6140.12, *Nondiscretionary Assistance Programs*

.120 The AICPA Accounting Standards team recently released another nonauthoritative question and answer (Q&A), commonly referred to as a TPA, pertaining to not-for-profit organizations. TPA 6140.12,

Nondiscretionary Assistance Programs, has been posted to the AICPA Web site at www.aicpa.org/members/div/acctstd/general/tpafin4.htm. It will also be included in the next update of the AICPA publication titled *Technical Practice Aids*, copies of which are available through the AICPA order department at (888) 777-7077. AICPA members with questions on these TPAs should call the AICPA's Technical Hotline, which provides nonauthoritative guidance on accounting and attest issues, at (888) 777-7077.

Auditing and Attestation Pronouncements and Guidance Update

.121 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

.122 To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i>
SAS No. 100	<i>Interim Financial Information</i>
SAS No. 101	<i>Auditing Fair Value Measurements and Disclosures</i>
SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i>

SAS No. 101, Auditing Fair Value Measurements and Disclosures

.123 The Auditing Standards Board issued SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 328), in January 2003 to establish standards and provide guidance on auditing fair value measurements and disclosures contained in financial statements. In particular, it addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. Fair value measurements of assets, liabilities, and components of equity may arise from both the initial recording of transactions and later changes in value. Changes in fair value measurements that occur over time may be treated in different ways under generally accepted accounting principles (GAAP). For example, GAAP may require that some fair value changes be reflected in net income and that other fair value changes be reflected in other comprehensive income and equity. Of course, in not-for-profit organizations, all changes are included in the change in net assets for the period.

.124 While SAS No. 101 provides guidance on auditing fair value measurements and disclosures, evidence obtained from other audit procedures also may provide evidence relevant to the measurement and disclosure of fair values. For example, inspection procedures to verify existence of an asset measured at fair value also may provide relevant evidence about its valuation, such as the physical condition of the asset. Refer to the Statement for effective date information.

New Auditing Interpretations

.125 Auditing Interpretations are issued by the Auditing Issues Task Force of the Auditing Standards Board (ASB) to provide timely guidance on the application of ASB pronouncements. Interpretations are reviewed by the ASB but are not as authoritative as ASB statements. 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*.

.126 The new Interpretations listed below are available on the AICPA Web site at www.aicpa.org/members/div/auditstd/announce/index.htm.

Interpretation No. 12, "The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Changes in the Year of Adoption," of SAS No. 1, section 420, *Consistency of Application of Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 9420).

Interpretation No. 15, "Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations," of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508).

Interpretation No. 2, "The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals," of SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 9326).

Interpretation No. 16, "Effect on Auditor's Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940," of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508).

Accounting Pronouncements and Guidance Update

.127 Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated with Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions</i>
FASB Statement No. 148	<i>Accounting for Stock-Based Compensation—Transition and Disclosure</i>
FASB Statement No. 149	<i>Amendment of Statement 133 on Derivative Instruments and Hedging Activities</i>
FASB Statement No. 150	<i>Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity</i>
FASB Interpretation No. 45	<i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i>
FASB Interpretation No. 46	<i>Consolidation of Variable Interest Entities</i>
FASB Technical Bulletin No. 01-1	<i>Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets</i>

SOP 02-2	<i>Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator</i>
AICPA Audit and Accounting Guide	<i>Audits of Depository and Lending Institutions; Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies</i>
Questions and Answers	<i>FASB Statement No. 140</i>

FASB Statement No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities

.128 The FASB issued its Statement No. 149 in April 2003, which amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Refer to the Statement for effective date information.

FASB Interpretation No. 46, Consolidation of Variable Interest Entities

.129 This Interpretation of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, addresses consolidation by business enterprises of variable interest entities,⁵ which have one or both of the following characteristics:

1. The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, which is provided through other interests that will absorb some or all of the expected losses of the entity.
2. The equity investors lack one or more of the following essential characteristics of a controlling financial interest:
 - a. The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights
 - b. The obligation to absorb the expected losses of the entity if they occur, which makes it possible for the entity to finance its activities
 - c. The right to receive the expected residual returns of the entity if they occur, which is the compensation for the risk of absorbing the expected losses

.130 Not-for-profit organizations subject to the consolidation requirements of SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, are not subject to FASB Interpretation No. 46, except that they may be related parties for purposes of applying paragraphs 16 and 17 of the Interpretation. In addition, a not-for-profit entity used by a business enterprise in a manner similar to a variable interest entity in an effort to circumvent the provisions FASB Interpretation No. 46 is subject to the Interpretation. Readers should refer to the Interpretation for additional exceptions to the scope of this Interpretation and for the effective date information.

SOP 02-2, Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator

.131 This SOP amends the AICPA Audit and Accounting Guide *Health Care Organizations* (Guide), to address how nongovernmental not-for-profit health care organizations should report gains or losses on hedging

⁵ The exposure draft that preceded this Interpretation referred to the entities subject to its requirements as special-purpose entities (SPEs). Because some entities that have been commonly referred to as SPEs may not be subject to this Interpretation and other entities that have not commonly been referred to as SPEs may be subject to this Interpretation, the Financial Accounting Standards Board decided to use the term *variable interest entity*.

and nonhedging derivative instruments under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended. This SOP requires the following:

- Not-for-profit health care organizations should apply the provisions of FASB Statement No. 133 (including the provisions pertaining to cash flow hedge accounting) in the same manner as for-profit enterprises.
- Not-for-profit health care organizations should provide all the disclosures required by paragraph 45 of FASB Statement No. 133, including disclosures related to reclassifications into earnings of gains and losses that are reported in accumulated other comprehensive income. Although those organizations are not otherwise required to report changes in the components of comprehensive income pursuant to paragraph 26 of FASB Statement No. 130, *Reporting Comprehensive Income*, such organizations should separately disclose the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator (earnings measure), the related net change associated with current period hedging transactions, and the net amount of any reclassifications into the performance indicator in a manner similar to that described in paragraph 47 of FASB Statement No. 133.

.132 The SOP also amends the Guide to clarify that the performance indicator (earnings measure) reported by not-for-profit health care organizations is analogous to income from continuing operations of a for-profit enterprise. Refer to the Statement for effective date information.

Upcoming Q&As on FASB Statement No. 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*

.133 The Accounting Standards Team of the AICPA is releasing question and answer guidance about key FASB Statement No. 136 issues. These Q&As will be posted to the AICPA Web site in June and will be incorporated into the AICPA TPAs afterwards. Readers should be alert to the issuance of this guidance.

On the Horizon

.134 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that are especially relevant to the NPO industry. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.135 The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft.

<i>Standard Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
FASB	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft email list" in the subject header field to help process the submissions more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

New Framework for the Audit Process

.136 The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB has issued a series of exposure drafts in early 2003. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

.137 Some of the more important changes to the standards that have been proposed are the following:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to the assessment of the risk of material misstatement of the financial statements (Among other things, this will improve the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.)
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

.138 You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Combinations of Not-for-Profit Organizations

.139 In November 1999, the FASB affirmed its earlier decision to undertake a project on combinations of NPOs that is separate from its business combinations project. As a result of that decision, combinations of NPOs are excluded from the scope of FASB Statement No. 141, *Business Combinations*. The FASB also agreed to delay the effective date of FASB Statement No. 142, *Goodwill and Other Intangible Assets*, as it applies to combinations of NPOs, until the FASB addresses the issues related to such combinations.

.140 The objective of this project is to develop guidance on the accounting and reporting for combinations of NPOs. As of the March 17, 2003 meeting, the FASB completed its deliberations related to the following issues:

- The method of accounting for combinations of NPOs
- The criteria to be used to identify the acquiring NPO
- Recognition of goodwill subsequent to acquisition
- Recognition of goodwill at date of acquisition
- The disclosures required by NPOs
- The effective date and transition method to be applied by NPOs

.141 For a tentative summary of the decisions reached by the Board so far on the combinations of NPO organizations go to www.fasb.org and into project updates. An exposure draft is planned for the third quarter of 2003. Readers should be alert for the issuance of a final Statement.

.142 Readers should also be aware of the ongoing work by the FASB on its consolidation project. On February 23, 1999, the FASB released an exposure draft (revised) of a proposed FASB Statement, *Consolidated Financial Statements: Purpose and Policy*, which would supersede FASB Statement No. 94 and amend ARB No. 51, APB Opinion Nos. 16 and 18, and FASB Statement Nos. 15, 57, and 65. The provisions of SOP 94-3 will be reconsidered as the FASB issues final standards. In the meantime, readers should be alert to the fact that NPOs continue to be covered by SOP 94-3 in this area. In January 2003, the FASB issued FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*. The FASB now plans to continue its consideration of the broader proposals in the 1999 exposure draft.

Emerging Issues Task Force Discussion on Other-Than-Temporary Impairment

.143 The Emerging Issues Task Force (EITF) of the FASB discussed proposed guidance for assessing other-than-temporary impairment at the March 20, 2003 EITF meeting. This proposed guidance would apply to investments accounted for under the cost method or the equity method, investments classified as either available-for-sale or held-to-maturity under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (including individual securities and mutual funds), and investments accounted for under FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. The guidance would not apply to investments within the scope of EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." The proposed guidance is expected to address the following: (1) determination as to whether an investment is impaired, (2) determination as to whether an impairment is other-than-temporary, and (3) recognizing an impairment loss equal to the difference between the investment's carrying amount and its fair value (measured as of the date of the financial statements). Additional discussion is anticipated at a future EITF meeting. Readers should be alert to any final consensus reached on this issue.

Proposed FASB Staff Position, *Applicability of FASB Interpretation No. 46, Consolidation of Variable Interest Entities, to Entities Subject to the AICPA Audit and Accounting Guide Health Care Organizations*

.144 The FASB has issued a proposed FASB Staff Position (FSP) on FASB Interpretation No. 46. The FSP addresses whether health care NPOs should follow FASB Interpretation No. 46. Paragraph 4(a) of the Interpretation provides an exception for not-for-profit organizations subject to SOP 94-3. Not-for-profit organizations subject to the AICPA Audit and Accounting Guide *Health Care Organizations* (Audit Guide), are not subject to SOP 94-3. The FSP is expected to answer the question "Do the requirements of FASB Interpretation No. 46 apply to those organizations?" The FSP states that all not-for-profit organizations are excluded from FASB Interpretation No. 46, including health care organizations subject to the Audit Guide. However, a not-for-profit entity used by a business enterprise in a manner similar to a variable interest entity in an effort to circumvent the provisions of FASB Interpretation No. 46 is subject to the Interpretation. Readers should be alert to any final issuance.

AICPA Audit and Accounting Products and Services

AICPA

Web Site

.145 AICPA Online (www.aicpa.org) is the AICPA's Web site on the Internet. The site offers users the opportunity to stay abreast of developments in accounting and auditing. Online resources include professional news, membership information, state and federal legislative updates, AICPA press releases, speeches, exposure drafts, and a list of links to other accounting- and finance-related sites. The AICPA Web site also features a "Talk to Us" section, allowing users to send e-mail messages directly to AICPA representatives or teams. The AICPA Web site includes a separate section that deals with Circular A-133 audit issues, including a document that provides unofficial answers to frequently asked questions, at www.aicpa.org/belt/a133main.htm.

Order Department (Customer Service Center)

.146 To order AICPA products, call the Customer Service Center at (888) 777-7077 or fax to (800) 362-5066. 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., Eastern Time. Also, visit the CPA2Biz Web site at www.cpa2biz.com to obtain product information and place online orders.

Industry Conference

.147 The AICPA will hold its Ninth Annual Not-for-Profit Organizations Industry Conference on June 12–13, 2003 (with preconference workshops on June 11), in Washington, D.C. The conference is designed for both practitioners and not-for-profit organization financial executives, and will provide technical information for those decision makers. Also coming up is the AICPA Governmental and Not-for-Profit Training Program on October 20–22, 2003 in Baltimore, MD and the AICPA Not-for-Profit Financial Leaders Forum on November 20–21, 2003, in San Francisco, CA. For further information, call the AICPA CPE Conference Hotline at (888) 777-7077 or visit the AICPA Web site at www.aicpa.org.

Accounting and Auditing Technical Hotline

.148 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.149 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

.150 The AICPA offers many continuing professional education (CPE) courses related to NPOs, 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 (product no. 743269kk)
- Form 990: AICPA's Answer to Unlocking the Tax Complexities (product no. 731053kk)
- Advanced Accounting and Auditing Problems for NPOs (product no. 730127kk)
- Advanced Auditing of HUD-Assisted Projects (product no. 730187kk)
- Applying A-133 to Nonprofit and Governmental Organizations (product no. 730197kk)
- Audits of HUD-Assisted Projects (product no. 730292kk)
- Analytical Procedures for Nonprofit Organizations (product no. 730211kk)
- Cost Allocation Methods for Not-for-Profit Organizations (product no. 730411kk)
- Managing Nonprofit Organizations Like a Business (product no. 730342kk)
- NEW EDITION! Nonprofit Accounting and Auditing Update (2002–2003 Edition) (available in text [product no. 732066kk] and video [product no. 182065kk])
- Nonprofit Auditing: Auditing Financial Results and Compliance Requirements (product no. 737052kk)
- Tax Mysteries of Private Foundations (product no. 732242kk)
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations (product no. 734405kk)

- Getting Started with Not-for-Profit Organization Tax Issues (product no. 733803kk)
- Nonprofit Organizations Guide to Advanced Tax Planning (product no. 736763kk)
- Using the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*
- Workpaper Techniques for Government and Nonprofit Organizations (product no. 732630kk)
- The Revised Yellow Book: Government Auditing Standards (product no. 736110kk)
- Using Competition for Performance Improvement: A Resource for Practitioners Advising Governments and Not-for-Profits (product no. 056507kk)

For more information about AICPA CPE courses, call the AICPA (Member Satisfaction) at (888) 777-7077 or visit the AICPA Web site at www.aicpa.org.

Online CPE

.151 AICPA InfoBytes, offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. Selected as one of *Accounting Today's* top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay \$149 (\$369 nonmembers) for a new subscription and \$119 (\$319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

Not-for-Profit Organizations Checklists

.152 The AICPA Accounting and Auditing Publications Team publishes *Checklists and Illustrative Financial Statements for Not-for-Profit Organizations* (product no. 008983kk), a nonauthoritative publication designed to help those preparing reports and financial statements of NPOs.

Practice Aids

.153 *Financial Statement Presentation and Disclosure Practices for Not-for-Profit Organizations* is a comprehensive Practice Aid (product no. 006605kk) that illustrates a wide variety of financial statement formats and disclosures for NPOs.

.154 *Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations*, is a two-volume set (product no. 006602kk) containing 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.

.155 *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide* (product no. 006613kk), is a Practice Aid that provides CPAs with the most recent information related to the implementation of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*.

Technical Practice Aids

.156 *AICPA Technical Practice Aids* includes questions received by the AICPA Technical Hotline on various subjects and the responses to those questions. Sections 6140 and 6960 of *Technical Practice Aids* include questions and answers specifically pertaining to NPOs. *Technical Practice Aids* is available both as a subscription service (product no. G01013kk) and in paperback form (product no. 005142kk).

Help Desk—AICPA publications can be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077, or faxing a request to (800) 362-5066.

References for Additional Guidance

General Accounting Office

.157 The General Accounting Office (GAO) home page, on the Internet at www.gao.gov, contains links to hundreds of reports and testimony made before Congress each year on a variety of subjects, including accounting, budgeting, and financial management. Hard copies of GAO reports and testimony can be obtained from the GAO, P.O. Box 37050, Washington, DC 20013; phone (202) 512-6000; fax (202) 512-6061; or www.gao.gov/cgi-bin/ordtab.pl.

.158 GAO's Web site is updated daily and also includes Comptroller General decisions and legal opinions; GAO policy documents; and special publications. You may subscribe to GAO daily electronic alerts using the form at www.gao.gov/subtest/subscribe.html.

.159 The following publications are available on the GAO Web site at www.gao.gov/govaud/ybk01.htm. The first three publications also are available through the Superintendent of Documents, U.S. Government Printing Office (GPO), P.O. Box 371954, Pittsburgh, PA 15250-7954; phone (202) 512-1800; fax (202) 512-2250; or bookstore.gpo.gov/index.html.

- *Government Auditing Standards, 1994 Revision*—These standards relate to financial and performance audits of governmental organizations, programs, activities, and functions, and of governmental funds received by contractors, nonprofit organizations, and other nongovernmental organizations. (GPO Stock No. 020-000-00-265-4) There also is a codification of the 1994 standards that includes the Government Auditing Standards Amendments on the GAO Web site.
- *Government Auditing Standards: Amendment No. 1, Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems*—This amendment establishes a fieldwork standard requiring documentation in the planning of financial statement audits in certain circumstances. (GPO Stock No. 020-000-00275-1)
- *Government Auditing Standards: Amendment No. 2, Auditor Communication*—This amendment requires specific communication concerning the auditor's work on compliance with laws and regulations and internal control over financial reporting. It also requires 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. (GPO Stock No. 020-000-00274-3)
- *Government Auditing Standards: Amendment No. 3, Independence*—This amendment establishes independence standards for CPAs, non-CPAs, government auditors, and performance auditors. It addresses a range of auditor independence issues, including restrictions on nonaudit services.
- *Interpretation of Continuing Education and Training Requirements*—*Government Auditing Standards* establishes specific CPE requirements for auditors working on audits performed in accordance with those standards. This Interpretation guides audit organizations and individual auditors on implementing the CPE requirements by answering the most frequently asked questions from the audit community.

Other Guidance

.160 Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform, as described in the AICPA general *Audit Risk Alert*—2002/03 [AAM section 8010], and AICPA *Compilation and Review Alert*—2002/03 [AAM section 8015]. These Alerts may be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077 or faxing a request to (800) 362-5066. Obtaining product information and placing online orders can be done at www.CPA2biz.com. (The 2003/04 versions of these publications will be issued later in 2003).

.161 Copies of FASB publications referred to in this document may be obtained directly from the FASB by calling the FASB Order Department at (800) 748-0659.

.162 This Audit Risk Alert replaces *Not-for-Profit Organizations Industry Developments—2002*. The *Not-for-Profit Organizations 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 be appreciated. You may e-mail these comments to lwest@aicpa.org or write to:

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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 (NPOs) 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.

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 NPOs may find useful.

<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	www.aicpa.org
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com
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	www.idealists.org
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	www.asaenet.org

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
BBB Wise Giving Alliance	Promotes giving and helps contributors obtain accurate information about charitable organizations	www.give.org
Board Source	Resources to help strengthen not-for-profit organization boards of directors	www.boardsource.org/main.htm
The Chronicle of Philanthropy	Articles from the <i>Chronicle of Philanthropy</i> newspaper and links to other sites	www.philanthropy.com
CompassPoint Nonprofit Services	Workshops, consulting, publications, and other information and resources of interest to managers of not-for-profit organizations	www.supportcenter.org
Council on Foundations	Includes research, publications, and other information of interest to foundations and corporate donors	www.cof.org
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com/
Department of Housing and Urban Development: Office of Inspector General Real Estate Assessment Center	Information on programs, resources, and other matters	www.hud.gov/offices/oig/ www.hud.gov/offices/reac
The Electronic Accountant	World Wide Web magazine that features up-to-the minute news for accountants	www.electronicaccountant.com
Financial Accounting Standards Board	Information on the activities of this standard-setting body	www.fasb.org
FedWorld.Gov	U.S. Department of Commerce sponsored site providing access to government publications	www.fedworld.gov
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	www.fsforum.com
The Foundation Center	Information for not-for-profit organizations, donors, and researchers	www.fdncenter.org
Giving USA	American Association of Fund-Raising Counsel sponsored site providing information trends in giving and sources of support	www.aafrc.org
General Accounting Office	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Guidestar	Information on not-for-profit organizations and new resources for not-for-profit organizations and donors	www.guidestar.org

(continued)

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
Guide to WWW for Research and Auditing	Basic instructions on how to research	www.tetranet.net/
Hoovers Online	Online information on various companies and industries	www.hoovers.com
Independent Sector	A forum to encourage giving, volunteering, not-for-profit initiative, and citizen action	www.indepsec.org
Information for Tax-Exempt Organizations (an IRS site)	A Treasury Department site providing information and answers to frequently asked questions regarding tax-exempt organizations	www.irs.gov/
Internet Nonprofit Center	Includes the nonprofit locator, frequently asked questions, and other information	www.nonprofits.org
Management Assistance Program for Nonprofits	Includes the Nonprofit Manager's Library and other resources	www.mapnp.org
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	www.nacubo.org
The National Center for Charitable Statistics	Provides statistics on revenue and expenses of not-for-profit organizations	nccs.urban.org
The Nonprofit Genie	Advice, links to other sites, publications, and other information on not-for-profit organization management	www.genie.org
The Nonprofit Resource Center	Information and links to other sites covering financial management, governance, legal, and other matters	www.not-for-profit.org
The Nonprofit Risk Management Center	Provides information to help not-for-profit organizations control their risks	www.nonprofitrisk.org
The Nonprofit Times Online	Articles from the <i>Nonprofit Times</i> newspaper and links to other sites	www.nptimes.com
Tax Analysis Online	Provides information on current tax developments	www.tax.org
U.S. Department of Education	Information on programs, resources, and other matters	www.ed.gov
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
U.S. Office of Management and Budget	OMB information and literature	www.whitehouse.gov/OMB/
Vision Department	Information on the profession's Vision Project	www.cpavision.org

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AAM Section 8130

High-Technology Industry Developments—2002/03

How This Alert Can Help You

.01 This Audit Risk Alert can help you plan and perform your high-technology industry audits. The knowledge delivered by this Alert can assist you in achieving a more robust understanding of the high-technology business environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues and about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the high-technology industry and if you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

Industry and Economic Developments

The U.S. Business Environment

.04 As of the third quarter of 2002, anxious economists are downgrading their forecasts, and some crucial sectors of the economy are pushing the likelihood of a rebound into next year because of the abrupt slowdown in the economic recovery.

.05 For now, the overall economy is expanding, but sluggishly. Jobs are growing, but barely. And with a depressed stock market, concerns over a possible military action in Iraq, fears of terrorist strikes, and corporate scandals weighing on the national psyche, there is none of the exuberance that marked the recovery in the late 1990s.

.06 The economy appears to be in a struggle between declining business confidence and strong consumer spending. Eventually, consumer demand should overcome business wariness, unless cautious businesses cut so many jobs that consumers finally give up. The same dynamic was at work during the fall of 2001. After September 11, the business sector froze, the consumer sector did not, and eventually consumer demand jump-started the economy.

.07 The underlying economic fundamentals remain relatively sound and point toward a moderate economic growth scenario. However, stock market weakness, coupled with recent data releases, has prompted downward forecast revisions.

Stock Market Woes

.08 Accounting scandals and corporate bankruptcies have generated tremendous investor uncertainty, resulting in a dramatic decline in stock prices. While this is disconcerting, Wall Street scandals are not expected

to play a *significant* adverse role in consumer spending or overall economic growth. Furthermore, any negative economic impacts generated by stock price declines are expected by economists to be constrained to third-quarter activity.

.09 Potentially, the decline in stock market prices can affect real economic activity by reducing consumer wealth and by adversely affecting consumer buying attitudes. Both conditions could reduce consumer spending activity.

.10 Stock prices have declined throughout the first three quarters of 2002, resulting in a multitrillion dollar decline in wealth holdings. Most economists believe the decline in wealth will have a relatively small adverse impact on consumer spending. The wealth decline is primarily a temporary paper setback for investors. The underlying economic fundamentals are relatively sound and the profit picture facing corporate America is showing mixed signs of improvement. This suggests that once investors regain confidence in corporate financial reporting, the market will rebound strongly.

Current Monetary Policy

.11 In November 2002, for the first time in 11 months, the Federal Reserve Board lowered the federal funds rate to 1.25 percent, its lowest level in 41 years. At this point the Fed believes that the risks between inflation and very slow economic growth are balanced.

The Sarbanes-Oxley Act of 2002

.12 On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. The Act includes far-reaching changes in federal securities regulation that could represent the most significant overhaul since the enactment of the Securities Exchange Act of 1934. The Act prescribes a system of federal oversight of public auditors through a Public Company Accounting Oversight Board, a new set of auditor independence rules, new disclosure requirements applicable to public companies and insiders, and harsh civil and criminal penalties for persons who are responsible for accounting or reporting violations. The Act also imposes new restrictions on loans and stock transactions involving corporate insiders.

.13 A more complete summary of the Act is available on the AICPA Web site at www.aicpa.org/info/sarbanes_oxley_summary.htm and in the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

General Industry Trends and Conditions

.14 The economy and the stock market have been dominated by the high-technology industry in the past several years. The desire to enter this industry seems unaffected by strong competition and the tragic experience of some of the new high-tech companies that have gone bankrupt.

.15 The pervasive impact of high-technology on our overall economy has been dramatic. It is hard to pick up a newspaper without reading something about the so-called new economy, which is made up of all high-tech sectors. Discussions about the Internet, Web sites, portals, electronic commerce (e-commerce), electronic business (e-business), and dot-com companies abound. Analysts estimate that, over the past several years, technology spending accounted for about 30 percent of the growth in gross domestic product (GDP). In addition, technology has helped to increase productivity, which, in turn, has allowed our economy to grow at such a fast pace for so long without sparking inflation.

.16 However, some analysts now question whether the battered high-technology industry will ever regain its strength. History offers some insight to this question. A decade ago, the U.S. technology industry was left for dead. Asian chipmakers had grabbed nearly half of the global semiconductor market. Personal computers (PCs) were helpful at work but seemed of limited utility elsewhere. Investors didn't see much future and tech companies shrunk to their smallest share of stock market value in 15 years.

.17 But around that same time, a group of engineers at a federal lab in Illinois were writing a small program to make it easier for computer users to navigate the infant World Wide Web through graphical links instead of text-based menus. Their Mosaic program later became Netscape. It changed communications and commerce, and it ignited one of the greatest investment frenzies in history.

.18 Now, the technology industry is again in eclipse. The 100 largest tech companies have lost money in the aggregate for five straight quarters, according to Merrill Lynch & Co. And this time, the high-tech industry's troubles have a wider impact than ever, on both the stock market and the broader economy. Approximately 47 percent of business capital spending goes into tech equipment and software now, compared with 20 percent in 1990. On Wall Street, even after the steep plunge in tech shares, they still account for about 14.5 percent of the value of the Standard & Poor's 500 stock index—nearly twice their share at the bottom of the previous slump.

.19 But three times in the past 25 years, the tech industry has faced downturns and an uncertain future. Each time, new ideas, along with relentless improvements of existing products, brought the industry back to life in unforeseen ways, though some innovations took years to bear fruit. The 1990s boom fed on incremental advances in operating systems and the linking of PCs into office networks. Then, the Internet propelled the industry to unforeseen heights.

.20 What will be the next big thing? One intriguing innovation is Wi-Fi technology, a set of standards created to provide wireless office computer networks. Now it's spreading for an unintended purpose: to deliver Internet access to coffee shops, airports, and homes. Another breakthrough could emerge from the resolution of the thorny legal issues around computerized music and movies. A new generation of cheap sensor chips, all linked to the Internet, could create a boom in technologies that track commerce, machines, and even health.

.21 The biggest test will be the nature and ultimate impact of innovation. Pessimists say they don't see a "killer app" on the horizon. Optimists answer that the next big thing is rarely visible from the depths of a downturn. Products and companies may die, but innovation is a process greater than a series of products.

What Is High Technology and What Are Its Industry Segment Conditions?

.22 It is difficult to find common ground on the precise definition of the high-technology industry. According to the AEA (formerly known as the American Electronics Association), the high-tech industry is made up of 45 Standard Industrial Classification (SIC) codes. These sectors fall into three broad categories—high-tech manufacturing, communications services, and software and computer-related services.

.23 High technology is a lot like quality—people know it when they see it—but it is not easy to define. This means the definition of the high-technology industry varies greatly depending on the combination of products and services selected to define the industry. For the purposes of this Alert, we will use a definition that segments the industry into five classifications—personal computers; semiconductors; mainframes, servers, and storage; networking and telecommunications equipment; and software and services.

Personal Computers

.24 After 25 years of strong growth, the PC industry has reached maturity and its future growth will be determined by economic conditions. According to Computer Industry Almanac, Inc. (CIAI), future PC unit sales growth will remain below 10 percent, and economic recessions will produce PC sales contractions. However, the PC industry will see long-term growth, but year-to-year growth is no longer certain, according to CIAI. PCs-in-use will continue to grow in all regions of the world and will double by 2010 in many regions. PCs-in-use in the United States reached 175 million in 2001 and will pass 300 million by 2010. Worldwide PCs-in-use surpassed 525 million in 2001 and will top 1.1 billion units in 2007.

.25 According to research conducted by CIAI, in 2007 the PC industry will pass another milestone when worldwide PC sales will surpass 200 million units, but this is two years later than was expected in early 2000.

Western Europe and North America have the highest PC-adoption rates and consequently will have the slowest growth rates and the highest risk for PC sales declines during economic downturns. Annual PC sales now depend much more on replacement sales than sales to new customers. This means that the economic life of the average PC will become the largest factor in determining annual PC unit sales.

.26 Short product life cycles are a fundamental characteristic of this industry sector. For example, the life cycle of a desktop PC is thought to be two years or less, and it is estimated that up to 50 percent of profits for PCs and related products are generated in the first three to six months of sales. As a result, computer makers face the risk of inventory obsolescence. (See the "Inventory Valuation" section later in this Alert for a discussion of this issue.)

.27 Computer manufacturers may enter into hedging transactions to protect themselves from fluctuating prices of the components used in the production of computers. As a result, computer manufacturers may be affected by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

Semiconductors

.28 The worldwide semiconductor market is forecast to post double-digit growth in 2003, with revenue totaling \$171.8 billion, a 12.1 percent increase from 2002 estimates, according to Dataquest Inc., a unit of Gartner, Inc.

.29 In 2001, worldwide semiconductor revenue totaled \$152.5 billion, a 32 percent decline from 2000. In 2002, the market is beginning to see signs of recovery, as revenue is projected to reach \$153.3 billion, a 0.5 percent increase from 2001.

.30 The semiconductor market recovery in 2002 has progressed as expected, with strong growth in the first half of 2002 as inventories were replenished, and weaker growth in the second half of the year, according to analysts with Gartner Dataquest's semiconductor research group. Although semiconductor sales in the third quarter of 2002 held up reasonably well, benefiting from a degree of seasonal strength, that strength has not carried forward into the fourth quarter and highlights the poor state of electronic equipment production.

.31 The worldwide digital cellular handset market is one of the few bright spots in the semiconductor industry and is driven primarily by a replacement cycle as the industry shifts from second generation (2G) to 2.5 generation (2.5G) cellular, which is good news for semiconductor vendors because it increases demand for silicon-rich handsets.

.32 Gartner Dataquest analysts said that while PC unit production growth has stalled in 2002, a corporate PC replacement cycle is becoming overdue and cannot be put off much longer. A broader-based recovery in electronic equipment production, especially in the wired communications segment, is unlikely to begin until 2004, suggesting a limited impact on semiconductor sales in 2003. 2003 is forecast to be a transition year, as a phased recovery in end markets gradually works its way back to fuel incremental semiconductor sales growth.

.33 In this sector of the industry, where rapid replacement of capital assets is common, you may need to ensure that your clients have appropriately considered the provisions of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. (See the "Asset Impairment" section later in this Alert for further discussion on this topic.)

.34 Another implication for the shifting needs of product manufacturers and end users is the potential for rapid inventory obsolescence. New types of chips are continuously developed, quickly rendering older ones obsolete. Product life cycles continue to decrease, and communications protocols constantly change. As a result, you may need to consider an increased level of risk associated with inventory valuations. (For a further discussion, see the section titled "Inventory Valuation" later in this Alert.)

Mainframes, Servers, and Storage

.35 The worldwide server market grew 3.1 percent in the third quarter of 2002, as worldwide server shipments totaled 1.1 million, up from 1.07 million units in the third quarter of 2001, according to Dataquest Inc., a unit of Gartner, Inc. While the industry did grow, Gartner Dataquest analysts said the relatively poor performance of the market for the same quarter last year, due primarily to the terrorist attacks of September 11, must be considered when judging the change.

.36 The performance of the worldwide server market in the third quarter of 2002 should be interpreted with caution because of the issues that existed in the same quarter one year ago. The server market still looks cloudy, with the possibility of war in the Middle East further aggravating economic uncertainty, and continued constraints on information technology (IT) spending that make it hard to be optimistic about real recovery of the worldwide server market this year.

.37 The United States server market continued to show signs of recovery, with a 12.2 percent increase in the third quarter of 2002, and shipments of 488,858 units, up from 435,620 in the third quarter of 2001.

.38 As with other segments of the high-tech industry, there is the potential for rapid inventory obsolescence. As demand for new types of servers and storage systems increases, older types may become obsolete. As a result, you may need to consider an increased level of risk associated with inventory valuations. (For a further discussion, see the section titled "Inventory Valuation" later in this Alert.)

Networking and Telecommunications Equipment

.39 The international market for telecommunications equipment and services grew 11.1 percent last year, reaching nearly \$1.2 trillion, according to research by the Telecommunications Industry Association (TIA).

.40 Growth in the Mexican and Canadian markets was slow in 2001 as a result of the weakening economic climate in both countries, and the pace is expected to continue through the rest of this year. By 2003, however, a fully recovered economy will make room for double-digit increases in equipment spending. Spending on enterprise equipment will propel this growth with an expected increase of \$5.3 billion between 2001 and 2005, reaching \$16.8 billion. Spending on public network equipment will grow from \$5.5 billion in 2001 to \$8 billion in 2005.

.41 In Western Europe, telecommunications infrastructure and enterprise equipment spending fell 11.5 percent, with enterprise equipment dropping 9 percent and public network equipment seeing a sharp decline of 19.2 percent in 2001. TIA predicts the equipment market will begin to pick up in 2002, and enterprise equipment spending is projected to grow at a 5.4 percent combined annual growth rate (CAGR) through 2005.

.42 In Eastern Europe, enterprise equipment and public network spending are projected to grow at nearly equal rates. Enterprise spending will grow at a 10.4 percent CAGR, reaching \$17.5 billion in 2005, up from \$11.8 billion in 2001. Public network equipment spending will increase at a 9.2 percent CAGR over the same period, rising from \$3.3 billion to \$4.7 billion.

.43 Enterprise spending in Latin America is gaining ground on public network equipment spending. The latter will grow at a projected 8.8 percent compound annual rate during the 2001-through-2005 study period, compared to 9.3 percent expected growth compounded annually for enterprise equipment.

.44 A surge in demand for network infrastructure will dominate growth in the Asia-Pacific markets through 2005, predicts TIA. For the 2001-through-2005 study period, public network equipment spending will grow at a projected 17 percent CAGR to \$36.6 billion, and enterprise equipment spending will advance at 11.5 percent CAGR to \$122 billion.

.45 A jump in fiber spending is expected to come despite the recent economic downturn and a perceived excess of capacity in the network that caused an overall 13.8 percent decrease in carrier equipment expenditures to \$41 billion in 2001. Service provider purchases are projected to decrease 10.8 percent to \$36.5 billion in 2002, but the negative trend is beginning to turn, heralding positive growth in 2003.

.46 In the meantime, strong enterprise demand for bandwidth-hungry applications is driving the broadband market and reducing the current supply. Continuing a trend from 2000, the most immediate growth in carrier spending will be found in the related gear to get more out of existing fiber. New generations of optical switches and signaling gateways have proven their ability to streamline data transmission time and use less power, thus making fiber more affordable and easier to upgrade. Furthermore, some of the new optical switches that require later generations of fiber will offer such efficiencies that service providers will find it more cost-effective to lay additional fiber in the months ahead, rather than retrofit current network plant.

Software and Services

.47 The continued economic slump in business capital spending is changing the shape of the software industry as top-tier software vendors are gaining revenue share at the expense of the pure-play vendors, according to Dataquest Inc., a unit of Gartner, Inc.

.48 Dataquest analysts refer to these top-tier vendors as titan vendors (vendors that have achieved dominant market share in more than one software market segment by offering a diversified and often integrated line of software products). Pure-play vendors derive most of their software revenue from the sale of products within one market. The realities of the weak economy continue to shift the competitive advantage from pure-plays to titans.

.49 Software titans have deeper pockets and can withstand the economic challenges much easier than many pure-play vendors, which have smaller revenue streams and cash reserve, according to analysts with Gartner Dataquest's Software Industry Research group. This has caused struggling pure-play vendor solutions to be less desirable from a financial perspective, even though they can be a better solution to risk-averse decision makers. Loss of revenue, partly because of such reluctance in the marketplace, may indeed make bankruptcy or acquisition by a titan a self-fulfilling prophecy.

.50 Worldwide end-user spending on software is forecast to grow 3.6 percent in 2002, with revenue of \$76.9 billion, and increase to \$81.8 billion in 2003. In 2001, worldwide software revenue declined 5.7 percent, with revenue of \$74.2 billion.

.51 The first-half 2002 license revenue performance of enterprise software companies was lackluster because of the continued bad news concerning the U.S. and global economy that is inhibiting corporate purchases and stalling investment decisions.

.52 Tight IT budgets have meant that buyers cannot satisfy their pent-up demand for software projects to improve corporate business performance and IT infrastructure efficiencies. When budgets loosen in the second half of 2003 or the first half of 2004, the backlog of demand could cause a temporary growth surge that then settles down to normal growth rates.

Other Economic and Regulatory Issues

Broadband

.53 Leading high-technology associations, banded together as members of the High Tech Broadband Coalition (HTBC), say that swift action by the Federal Communications Commission (FCC) to achieve a minimal regulatory environment is needed to help speed broadband deployment and create an economic

rebound for the technology and telecommunications industries. HTBC is an ad hoc alliance of the leading trade associations of the computer, telecommunications equipment, semiconductor, consumer electronics, software, and manufacturing sectors committed to the rapid and ubiquitous deployment of fast, interactive, content-rich, and affordable broadband services.

.54 HTBC argues the broadband services market is distinct from the legacy voice market and has urged the FCC to refrain from imposing Section 251 unbundling obligations on incumbent local exchange carriers' (ILEC) new, last-mile broadband facilities, including fiber and DSL and successor electronics deployed on the customer side of the central office, used to provide broadband services. HTBC believes removal of these antiquated and burdensome regulations will produce the economic incentive needed for increased investment in broadband, facilities-based competition.

.55 President Bush and members of Congress acknowledge that hurdles and barriers could be standing in the way of broadband reaching its promise of revitalizing the national and global economy. The high-tech industry believes strongly that one important component of a broadband policy or strategy is ensuring that the regulatory framework fosters an environment that encourages all broadband competitors to upgrade, expand, and innovate across the wide variety of existing and future communications networks capable of supporting broadband services.

Audit Issues and Developments

Assessing Audit Risks in the Current Environment

.56 The proper planning and execution of an audit has always required you to have a thorough understanding of the high-tech industry and the nature of your client's business. For most audit firms, this in-depth understanding means that the most experienced partners and managers must become involved early and often in the audit process. In today's high-tech environment, your judgment, knowledge, and experience are even more important than they were in the past.

.57 During the past year, the U.S. economy has suffered some significant declines: consumer confidence has dropped, plant closings and layoffs have increased dramatically, profit margins for many companies have slipped, and many companies have failed.

.58 Periods of economic uncertainty lead to challenging conditions for companies attributable to potential deterioration of operating results, increased external scrutiny, and reduced access to capital. During such times, professional skepticism should be heightened and the status quo should be challenged.

.59 More specifically, in today's economic environment, you should keep the following points in mind as you plan and perform audits of high-tech clients.

- Understand how your client is affected by changes in the current business environment.
- Understand the stresses on your client's internal control over financial reporting, and how they may affect its effectiveness.
- Identify key risk areas, particularly those involving significant estimates and judgments.
- Approach the audit with objectivity and skepticism, notwithstanding prior experiences with or belief in management's integrity.
- Pay special attention to complex transactions, especially those presenting difficult issues of form versus substance.
- Consider whether additional specialized knowledge is needed on the audit team.

- Make management aware of identified audit differences on a timely basis.
- Question the unusual and challenge anything that doesn't make sense.
- Foster open, ongoing communications with management and the audit committee, including discussions about the quality of financial reporting and any pressure to accept less than high-quality financial reporting.
- When faced with a "gray" area, perform appropriate procedures to test and corroborate management's explanations and representations, and consult with others as needed.

.60 Specific points to keep in mind with respect to high-tech clients include:

- Consider the inappropriate use of "bill and hold" accounting, for example, in circumstances where the customer has not requested the delay in shipment or provided a ship date that is unreasonably long in the circumstances.
- Identify "round trip" transactions (see the "Accounting Issues and Developments" section later in this Alert for a detailed discussion of these transactions).
- Consider nonmonetary transactions.
- Pay attention to whether persuasive evidence of the arrangement exists at the time revenue is recognized and whether legal title to the goods has been transferred and the customer has all the risks and rewards of ownership at that time.
- Consider customers' rights of return, particularly those of distributors, and whether all the requirements of FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, have been satisfied for revenue recognition.

Professional Skepticism

.61 The third general audit standard stipulates that due professional care be exercised in planning and conducting an audit engagement. Due professional care requires that you exercise professional skepticism in gathering and evaluating audit evidence. Although you neither assume that management is dishonest nor assume unquestioned honesty, you should consider the increased risk associated with the potential increases in external pressure faced by management during the current economic climate.

.62 As a result of perceived external pressures, companies may be tempted to manage earnings by using nonrecurring transactions or through changes in the method of calculating key estimates, such as reserves, fair values, or impairments. Companies may also adopt inappropriate accounting practices resulting in improper recognition or omission of financial transactions. Material nonrecurring transactions may require special disclosure to facilitate the readers' understanding of the reported financial results, and the guidance in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, should be applied in reporting the effects of changes in estimates. Inappropriate transactions or accounting practices that may result in errors requiring adjustments of financial statements might include premature recognition of revenue, failure to appropriately accrue for contingent liabilities that are probable and estimable (whether within a range or at a point), and failure to record unpaid purchase invoices. Additionally, you should be particularly skeptical of fourth-quarter events that result in significant revenue recognition, loss accrual, or noncash earnings.

.63 The appropriate level of professional skepticism is needed when corroborating management's representations. Management's explanations should make business sense. Additionally, you may need to consider corroborating management's explanations with members of the board of directors or audit committee, and with transaction counterparties.

.64 Other indicators of potential increased accounting and reporting risk calling for increased professional skepticism include:

- Liquidity matters
 - The company is undercapitalized, is relying heavily on bank loans and other credit, and is in danger of violating loan covenants.
 - The company appears to be dependent on an initial public offering for future funding.
 - The company is having difficulty obtaining or maintaining financing.
 - The company is showing liquidity problems.
- Quality of earnings
 - The company is changing significant accounting policies and assumptions to less conservative ones.
 - The company is generating profits, but not cash flow.
- Management characteristics
 - Management's compensation is largely tied to earnings or the appreciation of stock options.
 - The company appears vulnerable to the weakening economic conditions, and management is not proactive in addressing changing conditions.
 - The company's management is selling their investment in company securities more than in the past.
 - There is a significant change in members of senior management or the board of directors.

Auditing Estimates

.65 The high-tech industry uses estimates in a variety of ways. For example, both the recognition and measurement of impairment losses require management to make estimates of future events or assumptions about current conditions.

.66 When auditing estimates, you should be familiar with Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342); the AICPA Practice Aid, *Auditing Estimates and Other Soft Information*; and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

.67 Currently, most segments of the high-tech industry are in decline. 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. Be skeptical of cash flow and other performance projections that assume overly optimistic upward trends will occur.

.68 Pay close attention to the underlying assumptions used by management when auditing accounting estimates. Management is responsible for making the estimates included in the financial statements. Those estimates may be based in whole or in part on subjective factors such as judgment based on experience about past as well as current events and about conditions it expects to exist. You should be alert to the possibility of management's overreliance on economic information based on favorable conditions to predict future outcomes.

Unusual Transactions

.69 Among the most frequently cited sources of financial reporting risk are significant adjustments or unusual transactions occurring at or near the quarter end or year end. Unusual transactions might include sales of assets outside the ordinary course of business, significant or unusual period-end revenues, introduction of new period-end sales promotion programs, and disposal of a segment of a business. These types of

transactions and adjustments often occur outside the company's ordinary course of business and, therefore, may not be subject to the checks and balances imposed by the internal control system.

.70 Key points include:

- Recognizing the underlying business purpose for entering into unusual transactions, as well as the resulting financial benefits or obligations.
- Whether unusual transactions—particularly those executed close to period end—are subject to effective controls.
- The impact of these types of transactions on annual and quarterly results, and whether they have been appropriately described in the company's financial reports.
- Existence of any "special" or "side" arrangements not considered in determining the appropriate accounting and disclosure for the transactions.
- Whether so-called nonstandard journal entries, including the adjusting entries made at the end of the closing process, are subject to appropriate review and oversight.

Consideration of Fraud

.71 SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides the primary guidance on your responsibilities for detecting fraud-related misstatements when performing a financial statement audit.¹ SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.

.72 Some examples of fraud risk factors that may exist in high-tech entities include the following:

- The use by management of unusually aggressive accounting practices in recognizing revenue.
- Complicated criteria for recognizing sales transactions, making it difficult to assess the completion of the earnings process. (For additional information about revenue-recognition-related issues, see the "Revenue Recognition" section of this Alert.)
- Inadequate responses or an unwillingness to respond to inquiries about known regulatory or legal issues.
- Significant related-party transactions.
- A significant portion of management compensation represented by bonuses, stock options, or other incentives.
- Excessive interest by management in maintaining or increasing an entity's stock price.

The general state of the recent economy may raise several fraud risk factors. For example, management may be under significant pressure to obtain additional capital, or the entity may depend on debt with debt covenants that are difficult to maintain under the circumstances.

.73 SAS No. 99 also identifies risk factors related to misstatements arising from fraudulent financial reporting, such as a high degree of competition or market saturation and rapidly changing technology or rapid product obsolescence. All of these factors are present in the high-tech industry, implying potential audit concerns.

¹ Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316A); amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230); and amends SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333). See the discussion of this new SAS in the "New Auditing and Attestation Pronouncements and Other Guidance" section later in this Alert.

Evaluating Going Concern

.74 A number of high-tech industry sectors have experienced intense competition, recurring operating losses, negative cash flows, and the inability to obtain debt or equity financing. These factors have resulted in a high rate of business failure. The current business environment and market conditions might lead to rapidly deteriorating operating results and liquidity challenges for some high-tech companies, particularly those with reduced access to capital. A company particularly sensitive to negative changes in economic conditions can rapidly develop a liquidity crisis and ultimately fail.

.75 Certain conditions, considered in the aggregate, may lead you to question the entity's ability to continue as a going concern. In general, conditions and events that might indicate caution about going-concern issues could include (1) negative trends, such as recurring operating losses; (2) financial difficulties, such as loan defaults or denial of trade credit from suppliers; (3) internal challenges, such as substantial dependence on the success of a particular product line or service; or (4) external matters, for example, disaster occurrences such as the attacks of September 11, pending legal proceedings, or loss of a principal supplier. Also consider the case of an entity's excessive and unusual reliance on external financing, rather than on money generated from the company's own operations as a going-concern issue.

.76 Key in evaluating these risk factors is whether:

- Existing conditions and events can be mitigated by management's plans and their effective implementation.
- The company has the ability to control the implementation of mitigating plans rather than depending on actions of others.
- The company's assumption about its ability to continue as a going concern is based on realistic, rather than overly optimistic, assessments of its access to needed debt or equity capital or its ability to sell assets in a timely manner.
- Liquidity challenges have been appropriately satisfied and disclosed.

When evaluating management's plans to continue as a going concern, an appropriate level of professional skepticism is important. For example, you may want to scrutinize the company's assumptions to continue as a going concern to assess whether those assumptions are based on overly optimistic or "once-in-a-lifetime" occurrences.

.77 Key factors in your evaluation of the ability to continue as a going concern are part of the guidance provided in 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).

Auditor's Responsibilities Related to a Going-Concern Issue

.78 Auditors should be aware of their responsibilities pursuant to SAS No. 59 (AU sec. 341.02 and .03b). That statement provides guidance about conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS) to evaluate whether there is substantial doubt about a client's ability to continue as a going concern for a reasonable period of time.

.79 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, or the ability to remain a going concern, 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 you to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

.80 If there is substantial doubt about the entity's ability to continue as a going concern, you should consider whether it is likely that management plans can mitigate existing conditions and events and whether those plans can be effectively implemented. If you obtain sufficient competent evidential matter to alleviate doubts about going-concern issues, you should give consideration to the possible effects on the financial statements and the adequacy of the related disclosures. If, however, after considering identified conditions and events, along with management's plans, you conclude 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, refer to the specific guidance set forth under SAS No. 59.

Businesses in Bankruptcy Reorganization

.81 For those high-tech entities or operations that are under bankruptcy reorganization pursuant to Chapter 11 of the Bankruptcy Code, or are emerging from it, consider whether the company is following the accounting guidance of SOP 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*. Entities that filed for bankruptcy may have impairments that need to be recorded before fresh-start accounting under SOP 90-7.

Related-Party Transactions

.82 One of the more important, and yet more difficult, aspects of a financial statement audit is the identification of related parties and transactions with related parties. This aspect of the audit is important because of (1) the requirement under GAAP to disclose material related-party transactions and certain control relationships, (2) the potential for distorted or misleading financial statements in the absence of adequate disclosure, and (3) the instances of fraudulent financial reporting and misappropriation of assets that have been facilitated by the use of an undisclosed related party. See the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] for an in-depth discussion of related-party transactions.

Inventory Valuation

.83 The primary literature on inventory accounting is Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapters 3A and 4, which provide 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, last-out).

.84 Whether inventory is properly stated at lower of cost or market can be a very significant issue for high-technology audit clients because of the rapid changes that can occur in many areas of the industry, and the need for entities to keep up with the newest technology. Examples of factors that may affect inventory pricing include:

- Changes in a product's design that 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 that 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 technology, that may affect salability.
- Changes in foreign economies that could result in such situations as slowdown of sales to that region or lower-priced imports from that region.

- Changes in technology to produce high-technology products that can give competitors a selling-price advantage.
- Changes in regulations that could affect the competitive environment.
- The entity's own product changes that may not be well researched due to the pressure to introduce new products quickly, resulting in poor sales or high returns.

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, you should consider whether the carrying amount of inventories is appropriate.

.85 You can look at many factors in determining the proper valuation of inventories. A few examples of 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 that could 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

.86 These are not the only issues of importance to consider. You may need to address many other issues, including the client's taking of physical inventories in high-technology entities. Consider guidance set forth in SAS No. 1, section 331, *Inventories* (AICPA, *Professional Standards*, vol. 1, AU sec. 331.09–.13). Among the issues for your consideration are the following:

- When dealing with some difficult types of inventory, such as chemicals used in the process, you may need to take samples for outside analysis. The work of a specialist may also be needed, and in this case you should follow the guidance set forth in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).
- The extent to which raw materials have been converted to work-in-process will need to be determined to assess 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, as well as field service inventories for use in servicing the client's products, will need to be considered.

.87 In addition, the SEC staff believes that inventory reserves create a new cost basis and thus cannot be subsequently reversed into income as a change in estimate if, for example, demand were forecasted to pick up and thereby a previously established excess and obsolete inventory reserve were deemed no longer necessary.

.88 There are also risks posed by the use of contract manufacturers. In many of those circumstances the hardware vendor will provide the contract manufacturer with a guarantee against its loss due to excess raw material inventory (and, possibly, against the value added in the manufacturing or assembly process) that would occur if the vendor were to reduce purchases beyond a certain point. Such a guarantee may represent a contingent loss that needs to be recognized or disclosed under FASB Statement No. 5, *Accounting for Contingencies*. The disclosure requirements of FASB Statement No. 47, *Disclosure of Long-Term Obligations*, also need to be considered.

Revenue Recognition

.89 Revenue recognition continues to pose significant audit risk to auditors. The high-technology industry represents one of the more challenging industries when it comes to the topic of revenue recognition.

.90 Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, summarizes the SEC staff's views in applying GAAP to selected revenue recognition issues. SAB No. 101 presents various fact patterns, questions, and interpretive responses concerning whether the following criteria of revenue recognition are met:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been rendered.
- The seller's price to the buyer is fixed or determinable.
- Collectibility is reasonably assured.

.91 Another SEC publication, *SAB No. 101: Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers*, addresses recurring questions from preparers, auditors, and analysts about how to apply the guidance in SAB No. 101 to particular transactions.

.92 SAB No. 101 reflects the basic principles of revenue recognition in GAAP and does not supersede any existing authoritative literature. Accordingly, while SAB No. 101 is directed specifically to transactions of public companies, management and auditors of nonpublic companies may find the guidance helpful in analyzing revenue recognition matters.

.93 The SEC continues to see instances of questionable and inappropriate revenue recognition practices. Significant issues encountered recently include:

- Complex arrangements that provide for separate, multiple deliverables (for example, multiple products and/or services), at different points in time, during the contract term.
- Nonmonetary (for example, barter) transactions where fair values are not readily determinable with a sufficient degree of reliability.

.94 The SEC has requested that the Emerging Issues Task Force (EITF) address certain of these issues to clarify the application of GAAP in these transactions. However, the SEC staff generally believes that the existing accounting literature provides analogous guidance for a number of these issues, including SOP 97-2, *Software Revenue Recognition*; APB Opinion No. 29, *Accounting for Nonmonetary Transactions*; SOP 81-1, *Accounting for Performance of Construction-Type and Production-Type Contracts*; FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*; and FASB Concept Statement No. 6, *Elements of Financial Statements*.

AICPA's Audit Guide on Revenue Recognition

.95 The AICPA Audit Guide, *Auditing Revenue in Certain Industries*, assists auditors in auditing assertions about revenue in selected industries not covered by other AICPA Audit and Accounting Guides. You can look to this Guide for descriptions and explanations of auditing standards, procedures, and practices as they relate to auditing assertions about revenue in both the computer software and high-tech manufacturing industries.

.96 This Guide:

- Discusses the responsibilities of management, boards of directors, and audit committees for reliable financial reporting.
- Summarizes key accounting guidance regarding whether and when revenue should be recognized in accordance with GAAP.
- Identifies circumstances and transactions that may signal improper revenue recognition.
- Summarizes key aspects of the auditor's responsibility to plan and perform an audit under GAAS.
- Describes procedures that the auditor may find effective in limiting audit risk arising from improper revenue recognition.

Help Desk—You may order AICPA Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk) from the AICPA at (888) 777-7077 or go online at www.cpa2biz.com.

Auditing in a Paperless Environment

.97 When clients rely on technology to manage and analyze information, audit strategies change. Consider the following examples:

- Audit evidence that previously existed in paper form may be available electronically only. Accessing electronic audit evidence may require you to become proficient in the use of data-extraction or other audit software tools.
- The design and operation of internal control in a computer environment is much different than in a predominately manual environment.

As companies continue to expand their use of IT, you may need to become aware of the unique audit issues in a highly computerized environment. In addition, you should identify the risks of material misstatement that can arise during the transition from a highly manual environment to a more computerized operating environment.

.98 For further information and guidance on auditing in this paperless environment, see SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), and SAS No. 80, *Amendment to SAS No. 31, Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326).

How Employee Layoffs Might Affect Your Engagements

.99 Many companies continue to experience layoffs during the recent economic downturn. The layoff trend is broad based, affecting not only industries that were racing ahead until recent months, such as technology and telecommunications entities, but also businesses once thought to be recession-proof, for example, food and consumer products. Healthy companies are also using layoffs as a tool to reduce costs and accumulate earnings as they maneuver through this economic downturn. What do layoffs imply for you as you plan your engagements?

.100 If your high-technology clients are experiencing, or have experienced, layoffs, they will need to properly account for employee-related termination charges, such as severance package charges, restructuring charges, and voluntary separation charges. In addition, management may need to properly account for outplacement services offered to their departing employees and bonuses and educational allowances offered to assist employees in contending with the loss of their jobs. Here we offer some highlights of the accounting literature and other topics related to terminations to help provide guidance regarding issues related to layoffs.

- EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, addresses the timing of liability recognition for certain employee termination benefits in addition to the financial statement disclosures that should be made for those charges.²
- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, establishes standards for accounting for curtailments and termination benefits, among other issues. Practitioners should refer to paragraphs 6 through 14 for guidance on curtailment and paragraphs 15 through 17 for guidance on termination benefits.
- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, requires recording as a loss the effect of curtailment, for example, termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a segment of a business. Refer to paragraphs 96 through 99 for guidance on how to account for plan curtailment. The Statement also provides guidance on how to measure the effects of termination benefits in paragraphs 101 and 102.
- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, an amendment of FASB Statements No. 5, *Accounting for Contingencies*, and No. 43, *Accounting for Compensated Absences*, requires that entities providing postemployment benefits to their former or inactive employees accrue the cost of such benefits. Accrual would occur in accordance with FASB Statement No. 5, *Accounting for Contingencies*, when four conditions are met. Inactive employees include those who have been laid off, regardless of whether they are expected to return to work. Postemployment benefits that can be attributed to layoffs can include salary continuation, supplemental unemployment benefits, severance benefits, job training and counseling, and continuation of benefits, such as health care benefits and life insurance coverage.

FASB Statement No. 112 does not require that the amount of postemployment benefits be disclosed. The financial statement shall disclose if an obligation for postemployment benefits is not accrued because the amount cannot be reasonably estimated.

- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, addresses disclosures only (that is, not measurement or recognition) and standardizes the disclosure requirements for pensions and other postretirement benefits. Among other disclosures, the Statement requires the disclosure of the amount of any gain or loss recognized due to a settlement or curtailment. Additionally, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event are required to be disclosed.
- SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560), describes matters related to subsequent events. Use this guidance as you inquire of and discuss with the management matters involving unusual terminations of participants, such as terminations arising from a sale of a division or layoffs, in addition to other matters.
- Significant layoffs can have a serious effect on an entity's internal control structure and financial reporting and accounting systems. Employees who remain at the company may feel overwhelmed by their workloads, may have insufficient time to complete their tasks completely and accurately, and may be performing too many tasks and functions. With additional workloads and requirements

² EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, will be superseded upon the effective date of FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. See the "New Accounting Pronouncements and Other Guidance" section of this Alert for a discussion of this pronouncement.

for the performance of added tasks, the company might experience challenges to maintaining an adequate segregation of duties in addition to other experiences affecting internal control.

- The auditor may need to consider the possible effects that key unfilled positions can have on internal control. Entities that have experienced strong financial reporting and accounting controls before layoffs could see those controls deteriorate due to the lack of employees and to redefined employee tasks.

.101 Consider these issues related to employee layoffs when you plan and perform the audit and you assess control risk. Remember that gaps in key positions, and other changes related to reorganization or release of employees, may cause control weaknesses representing reportable conditions that you should communicate to management and the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended. Also see SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, which can help provide a framework to help the auditor obtain an understanding of internal control.

Accounting Issues and Developments

IRU Capacity Swaps

.102 The SEC staff has communicated to the SEC Regulations Committee the following staff position regarding indefeasible right to use (IRU) capacity swaps.

.103 The SEC staff has concluded that all IRU capacity swaps consisting of the exchange of leases should be evaluated within paragraph 21 of APB Opinion No. 29. That is, if a swap involves leases that transfer the right to use similar productive assets, the exchange should be treated as the exchange of similar productive assets, irrespective of whether the “outbound” lease is classified as a sales-type lease, direct financing lease, or operating lease and irrespective of whether the “inbound” lease is classified as a capital lease or an operating lease. The staff believes that the lease classification criteria of FASB Statement No. 13, *Accounting for Leases*, are not an appropriate basis for an entity to “filter” a determination of whether the exchange involves similar productive assets. This conclusion is based on the thought that the right to use an asset—that is, a lease—is in fact an asset and not a service contract, irrespective of whether such asset is recognized in a company’s balance sheet.

.104 This conclusion would require that IRU capacity swaps involving the exchange of leases be recognized based on the carrying value of the assets exchanged, rather than on fair value. The staff did point out that exchanges involving sufficient boot would still be treated as part monetary and part nonmonetary per EITF Issue No. 01-2, *Issues Related to the Accounting for Nonmonetary Transactions*.

.105 The staff expects that registrants will apply this guidance historically to IRU capacity swap transactions that occurred in prior years and, if appropriate, restate their financial statements. The chief executive officer and chief financial officer should be advised to give consideration to this matter before certifying the financial statements previously filed with the SEC.

Revenue Recognition

Income Statement Classification

.106 The appropriate classification of amounts within the income statement or balance sheet can be as important as the appropriate measurement or recognition of such amounts. In the current environment where revenue growth may not be as robust as originally projected, the auditor needs to be particularly

concerned about income statement misclassifications designed to increase reported revenue (for example, reporting agency transactions on a gross basis and showing sales discounts as a marketing expense rather than a revenue reduction). Several EITF consensus provisions provide guidance on the proper classification of certain revenue and expense items. For example, consider EITF Issues No. 99-17, *Accounting for Advertising Barter Transactions*; No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*; No. 00-10, *Accounting for Shipping and Handling Fees and Costs*; and No. 00-14, *Accounting for Certain Sales Incentives*; all of which were to be applied no later than in the December 31, 2000, financial statements for calendar year-end companies. SEC registrants should apply the guidance provided in SEC Regulation S-X regarding classification of amounts in financial statements.

Round Tripping

.107 Round tripping is another technique used to artificially inflate revenues and has appeared in several restatement scenarios. It involves transactions in which the company sells products and services to the same entity from which it buys products and services. Often the transactions happen in close temporal proximity and completing one transaction is dependent on completing the other. The fair value of both transactions may be overstated such that the company can report higher revenue at the “cost” of increased expenses. In addition, the products and services purchased back may not be used in the same period the revenue is recognized, resulting in more than a basic incorrect grossing-up of the income statement.

Vendor Financing

.108 The reduced liquidity of many customers is resulting in an increased use of vendor financing that goes well beyond normal trade terms. That requires consideration of whether the fee is fixed or determinable and/or collectible. In addition, provisions of APB Opinion No. 21, *Interest on Receivables and Payables*, need to be considered.

Nonmonetary or Barter Transactions

.109 Abuses in the area of nonmonetary or barter transactions have also been a focus of several recent restatements. The principal issues are whether there is a legitimate business purpose for the transaction and whether there is sufficient objective evidence of fair values. Also of concern is “disguised” barter transactions that are not analyzed as such due to the presence of “boot” or separation in time of transactions that are, in fact, negotiated together. Abuses are seen most often in situations where there is little hard inventoriable cost associated with the deliverables.

Business Combinations

.110 In June 2001, the FASB issued FASB Statement No. 141, *Business Combinations*, to address financial accounting and reporting issues for business combinations. This Statement supersedes APB Opinion No. 16, *Business Combinations*, and FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*.

.111 Under FASB Statement No. 141, all business combinations will be accounted for using one method—the purchase method. Given the economic environment of the high-technology industry, mergers and acquisitions have been, and continue to be, prevalent. Therefore, this change to a single method of accounting for business combinations may have major implications for high-tech companies.

.112 Under APB Opinion No. 16, business combinations were accounted for using one of two methods: the pooling-of-interests method (pooling method) or the purchase method. Use of the pooling method was required whenever 12 criteria were met; otherwise, the purchase method was used. Because those 12 criteria did not distinguish economically dissimilar transactions, similar business combinations were accounted for using different methods, producing dramatically different results.

.113 The provisions of FASB Statement No. 141 reflect a fundamentally different approach to accounting for business combinations. The single-method approach reflects the conclusion that virtually all business combinations are acquisitions and, thus, all business combinations should be accounted for in the same way that other asset acquisitions are accounted for—based on the values exchanged. Specifically, FASB Statement No. 141 changes the accounting for business combinations in APB Opinion No. 16 in the following respects:

- FASB Statement No. 141 requires that all business combinations be accounted for by a single method—the purchase method.
- In contrast to APB Opinion No. 16, which required separate recognition of intangible assets that can be identified and named, FASB Statement No. 141 requires that intangible assets be recognized as assets apart from goodwill if they meet one of two criteria—the contractual-legal criterion or the separability criterion.
- In addition to the disclosure requirements in APB Opinion No. 16, FASB Statement No. 141 requires disclosure of the primary reasons for the business combination and of the allocation of purchase price paid to the assets acquired and liabilities assumed by major balance sheet caption.

.114 The provisions of FASB Statement No. 141 apply to all business combinations initiated after June 30, 2001. The Statement also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later. (See the “New Accounting Pronouncements and Other Guidance” section of this Alert for additional information related to this standard.)

Goodwill and Other Intangible Assets

.115 The FASB issued FASB Statement No. 142, *Goodwill and Other Intangible Assets*, in June 2001. This Statement supersedes APB Opinion No. 17, *Intangible Assets*, and addresses how to account for intangible assets that are acquired individually or with a group of other assets upon their acquisition. This Statement also addresses how to account for goodwill and other intangible assets after they have been initially recognized in the financial statements. The nature and activities of the high-technology industry lend importance to this new standard. Be aware of its guidelines, especially regarding your high-technology clients.

.116 FASB Statement No. 142 changes the unit of account for goodwill and takes a very different approach to how to account for goodwill and other intangible assets subsequent to their initial recognition. Because goodwill and some intangible assets will no longer be amortized, the reported amounts of goodwill and intangible assets will not decrease at the same time and in the same manner as under previous standards. Specifically, FASB Statement No. 142 changes the subsequent accounting for goodwill and other intangible assets in the following respects:

- FASB Statement No. 142 adopts a more aggregate view of goodwill and bases the accounting for goodwill on the units of the combined entity into which an acquired entity is integrated. Those units are referred to as reporting units.
- APB Opinion No. 17 presumed that goodwill and all other intangible assets were wasting assets (that is, finite lived). FASB Statement No. 142 does not presume that those assets are wasting assets. Instead, goodwill and other intangible assets that have indefinite useful lives will not be amortized but, rather, will be tested at least annually for impairment.
- FASB Statement No. 142 provides specific guidance for testing goodwill for impairment. The annual test for goodwill impairment uses a two-step process that begins with an estimation of the fair value of a reporting unit. However, if certain criteria are met, the requirement to test goodwill for impairment annually can be satisfied without a remeasurement of the fair value of the reporting unit.

.117 The provisions of FASB Statement No. 142 are required to be applied starting with fiscal years beginning after December 15, 2001. This Statement is required to be applied to all goodwill and other intangible assets recognized in the financial statements at that date. Goodwill and intangible assets acquired after June 30, 2001, will be subject immediately to the nonamortization provisions of FASB Statement No. 142.

.118 Because there have been numerous combinations of high-tech companies in recent years, and because goodwill may represent a significant asset on the balance sheets of these combined companies, you should carefully consider the impact of any such change on your high-tech clients. Specifically, such a change will necessitate the need to identify the reporting units of the organization and test for impairment of goodwill at the reporting unit level. This process will require extensive valuation judgments and calculations.

.119 A valuable tool to use when auditing or valuing intangibles is the AICPA Practice Aid *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries* (product no. 006609kk).

Recent EITF Issues and AICPA TPAs Relevant to the High-Tech Industry

.120 Auditors of high-tech companies should pay close attention to EITF issues and AICPA Technical Practice Aids (TPAs) because in the past several years the EITF and the AICPA addressed a number of topics relevant to the high-technology industry.

.121 The application of EITF consensus positions (category *c* of the GAAP hierarchy) effective after March 15, 1992, is mandatory under SAS No. 69, *The Meaning of Present Fairly in Accordance With Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 411), as amended.

.122 TPAs bring together for continuing reference selected technical questions and answers (nonauthoritative), SOPs (accounting as well as auditing and attestation), AcSEC Practice Bulletins, a list of Issues Papers of the Accounting Standards Division of the AICPA, and Practice Alerts of the AICPA SEC Practice Section Professional Issues Task Force.

Employee Stock Options

.123 As noted in last year's Alert, stock options are an important accounting-related area for your high-tech clients. Knowledgeable workers are the prime assets of high-tech businesses and are the key to wealth creation. Accounting for their compensation sometimes raises difficult accounting issues if high-tech companies include stock options in employee compensation packages. High-tech companies grant stock options to essential employees to attract, motivate, and retain them, in addition to granting stock options, awards of stock, or warrants to consultants, contractors, vendors, lawyers, finders, lessors, and others. Issuing equity instruments makes a lot of sense, partly because of the favorable accounting treatment and partly because the use of equity conserves cash and generates capital.

.124 The accounting for employee stock options has received renewed attention in recent months. Several major U.S. companies have announced their intentions to change their method of accounting for employee stock options to an approach that recognizes an expense for the fair value of the options granted in arriving at reported earnings. Recognizing compensation expense relating to the fair value of employee stock options granted is the preferable approach under FASB Statement No. 123, *Accounting for Stock-Based Compensation*. It also is the treatment advocated by an increasing number of investors and other users of financial statements.

.125 Due to these developments, as well as the increased scrutiny from the press, Congress, regulators, and others, the FASB is currently working on a project that would affect the way companies account for employee stock options. The FASB has recently issued an exposure draft, *Accounting for Stock-Based Compensation—Transition and Disclosure*, which would amend FASB Statement No. 123. See the discussion of this exposure draft in the "On the Horizon" section of this Alert.

.126 Currently, there are two permissible methods of accounting for employee stock options: APB Opinion No. 25, *Accounting for Stock Issued to Employees*, which uses the intrinsic value method, and FASB Statement No. 123, which uses the fair-value method. Most e-businesses choose APB Opinion No. 25, which is easier to apply.

.127 Stock options granted to consultants, contractors, and nonemployees for services rendered or goods purchased must be accounted for in accordance with FASB Statement No. 123. Accordingly, companies must use the fair value method, not the intrinsic value method. EITF Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other than Employees for Acquiring, or in Conjunction with, Selling Goods and Services*, offers guidance in applying FASB Statement No. 123 to these transactions.

.128 With the downturn in share prices of many e-businesses continuing throughout 2002, the stock options previously granted to many essential employees may now have lost much of their value. To retain these employees, many companies may reprice the options. FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, is an interpretation of APB Opinion No. 25, and provides that “if the exercise price of a fixed stock option award is reduced, the award shall be accounted for as variable from the date of the modification to the date the award is exercised, is forfeited, or expires unexercised.” The EITF also addressed the repricing issue in EITF Topic No. D-91, *Application of APB Opinion No. 25, Accounting for Stock Issued to Employees*, and FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation, to an Indirect Repricing of a Stock Option*.

.129 FASB Interpretation No. 44 indicates that any modification or sequence of actions by a grantor to directly or indirectly reduce the exercise price of an option award causes variable accounting for the repriced or replacement award for the remainder of the award’s life. The change from a fixed to a variable plan triggers the requirement to record income statement charges (or credits) at each reporting date. So, although the intrinsic value of the option may be zero at the repricing (or modification) date, from that date until the final exercise (or expiration or forfeiture), the company must report an expense or reversal of that expense even though the options are not vested. This expense is the difference between the fair value of the shares at each balance-sheet date and the exercise price.

.130 The change in accounting triggered by repricing requiring compensation to be recorded has no effect on cash flow. However, it may reduce net income and earnings per share. Management should be made aware of the consequences of making any modification to their option plans and outstanding options and the financial statement impact of giving equity instruments to nonemployees.

Asset Impairment

.131 High-technology products are susceptible to rapid obsolescence. Long-lived assets used by enterprises involved in the manufacture of such products may require significant retooling to retain their usefulness. In some cases, these assets may not lend themselves to modification and could be rendered obsolete. Additionally, the high-tech industry has experienced a spurt of merger and acquisition activity. The elimination of duplicate functions, which typically accompanies a merger or acquisition, may affect the carrying amount of certain assets. These are just a few of the examples of the instances in which the carrying amounts of recorded assets may not be recoverable and the provisions of FASB Statement No. 144 may need to be applied.

.132 FASB Statement No. 144 provides the primary guidance on accounting for the impairment of long-lived assets. In general, the accounting for the impairment of long-lived assets depends on whether the asset is to be held and used or held for disposal.

Long-Lived Assets Held and Used

.133 Long-lived assets held and used should be reported at cost, less accumulated depreciation, and should be evaluated for impairment if facts and circumstances indicate that impairment may have occurred. Conditions or events such as the following may indicate a need for assessing the recoverability of the carrying amount of assets:

- A dramatic change in the manner in which an asset is used
- A reduction in the extent to which an asset is used

- Forecasts showing lack of long-term profitability
- A change in the law or business environment
- A substantial drop in the market value of an asset

.134 If events and 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.

.135 Lack of an asset-impairment evaluation system may indicate a material weakness in an entity's internal controls. Further, a lack of documentation generally increases the extent to which you must apply professional judgment in evaluating the adequacy of management's writedowns.

Long-Lived Assets to Be Disposed of by Sale

.136 Long-lived assets to be disposed of by sale (assets for which management has committed to a plan of disposal) should be reported at the lower of the 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.

.137 Although some long-lived assets might have previously been subject to APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, FASB Statement No. 144 amended APB Opinion No. 30. The provisions of FASB Statement No. 144 apply to all long-lived assets. Therefore, gains or losses on disposal of a discontinued operation are no longer measured on a net realizable value basis, and future operating losses are no longer recognized before they occur. (See the "New Accounting Pronouncements and Other Guidance" section of this Alert for additional information related to this Statement.)

Assets to Be Disposed of Other Than by Sale

.138 Assets that are to be abandoned, exchanged for a similar productive asset, or distributed to owners in a spin-off are to be considered as held and used until they are disposed of. If the asset is to be abandoned, the depreciable life is revised in accordance with APB Opinion No. 20, *Accounting Changes*. If the asset is to be exchanged for a similar productive asset or distributed to owners in a spin-off, an impairment loss is to be recognized at the date of exchange or distribution, if the carrying amount of the asset exceeds its fair value at that date.

.139 The provisions of FASB Statement No. 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early implementation encouraged. The provisions of the Statement generally are to be applied prospectively.

Research and Development Costs

.140 As noted in last year's Alert, ongoing innovation is the heart of competition in the high-tech industry and is required for survival. Consequently, most high-tech companies devote a substantial portion of their resources to research and development (R&D) activity. According to paragraphs 8(a) and 8(b) of FASB Statement No. 2, *Accounting for Research and Development Costs*:

Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service.

Development is the translation of research findings or other knowledge into a plan or design for a new product or process . . . whether intended for sale or use.

.141 High-tech management may reduce net loss or increase earnings by capitalizing R&D costs, which are significant for many companies in the high-technology industry. However, FASB Statement No. 2, as interpreted by FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, prohibits capitalization and requires R&D to be expensed when incurred, except for acquired R&D with alternative future uses purchased from others. In addition to the requirement to expense internal R&D, FASB Statement No. 2 requires disclosure in the financial statements regarding the total amount of R&D costs charged to expense.

.142 Some high-tech companies acquire their assets through mergers and acquisitions. One purpose of these business combinations is to acquire in-process R&D. You may need to hire a technology specialist to determine which acquired technology objects have alternative future uses. For clients with technology with alternative future uses, you should verify that they are properly valued and capitalized.

.143 The AICPA Practice Aid *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries* (product no. 006609kk) may be helpful in valuing these intangible assets. The Practice Aid is available from the AICPA Order Department at (888) 777-7077 or go online at www.cpa2biz.com.

New Auditing and Attestation Pronouncements and Other Guidance

.144 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 95	<i>Generally Accepted Auditing Standards</i>
SAS No. 96	<i>Audit Documentation</i>
SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i>
SAS No. 100	<i>Interim Financial Information</i>
SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>
SSAE No. 11	<i>Attest Documentation</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i>
SQCS No. 6	<i>Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>
Audit Guide	<i>Service Organizations: Applying SAS No. 70, as Amended</i>

(continued)

Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i>
Auditing Interpretation No. 4 of SAS No. 70	"Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls"
Auditing Interpretation No. 5 of SAS No. 70	"Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods"
Auditing Interpretation No. 12 of SAS No. 1	"The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Changes in the Year of Adoption"
Auditing Interpretation No. 14 of SAS No. 58	"Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing"
Auditing Interpretation No. 15 of SAS No. 58	"Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations"
Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Practice Alert 02-1	<i>Communications With the Securities and Exchange Commission</i>
Practice Alert 02-2	<i>Use of Specialists</i>
Practice Alert 02-3	<i>Reauditing Financial Statements</i>
Practice Aid	<i>Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide</i>
Practice Aid	<i>New Standards New Services: Implementing the Attestation Standards</i>
Practice Aid	<i>Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users</i>

.145 The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*

.146 SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316), supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316A); amends SAS No. 1, section 230 (AU sec. 230); and amends SAS No. 85, *Management Representations* (AU sec. 333), as amended. The Statement does not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02).³ However, SAS No. 99, establishes standards and provides guidance to

³ 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). 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 (see SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 312]), or fraud.

auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.⁴

.147 The following is an overview of the content of SAS No. 99, with references to paragraphs in the new fraud standard:

- *Description and characteristics of fraud.* This section describes fraud and its characteristics. (See paragraphs 5 through 12.)
- *The importance of exercising professional skepticism.* This section discusses the need for auditors to exercise professional skepticism when considering the possibility that a material misstatement due to fraud could be present. (See paragraph 13.)
- *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.* This section requires, as part of planning the audit, that there be a discussion among the audit team members to consider how and where the entity's financial statements might be susceptible to material misstatement due to fraud and to reinforce the importance of adopting an appropriate mindset of professional skepticism. (See paragraphs 14 through 18.)
- *Obtaining the information needed to identify risks of material misstatement due to fraud.* This section requires the auditor to gather information necessary to identify risks of material misstatement due to fraud, by:
 1. Inquiring of management and others within the entity about the risks of fraud. (See paragraphs 20 through 27.)
 2. Considering the results of the analytical procedures performed in planning the audit. (See paragraphs 28 through 30.)
 3. Considering fraud risk factors. (See paragraphs 31 through 33, and the Appendix, "Examples of Fraud Risk Factors.")
 4. Considering certain other information. (See paragraph 34.)
- *Identifying risks that may result in a material misstatement due to fraud.* This section requires the auditor to use the information gathered to identify risks that may result in a material misstatement due to fraud. (See paragraphs 35 through 42.)
- *Assessing the identified risks after taking into account an evaluation of the entity's programs and controls.* This section requires the auditor to evaluate the entity's programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation. (See paragraphs 43 through 45.)
- *Responding to the results of the assessment.* This section emphasizes that the auditor's response to the risks of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence (see paragraph 46). The section requires the auditor to respond to the results of the risk assessment in three ways:
 1. A response that has an overall effect on how the audit is conducted, that is, a response involving more general considerations apart from the specific procedures otherwise planned (See paragraph 50.)
 2. A response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed (See paragraphs 51 through 56.)

⁴ Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statements in accordance with generally accepted auditing standards. Chapter 1, "Attest Engagements," of Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101), and Statement on Standards for Consulting Standards (AICPA, *Professional Standards*, vol. 2, CS sec. 100) provide guidance to accountants relating to the performance of such services.

3. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls (See paragraphs 57 through 67.)

- *Evaluating audit evidence.* This section requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the assessment. (See paragraphs 68 through 74.) It also requires the auditor to consider whether identified misstatements may be indicative of fraud and, if so, directs the auditor to evaluate their implications. (See paragraphs 75 through 78.)
- *Communicating about fraud to management, the audit committee, and others.* This section provides guidance regarding the auditor's communications about fraud to management, the audit committee, and others. (See paragraphs 79 through 82.)
- *Documenting the auditor's consideration of fraud.* This section describes related documentation requirements. (See paragraph 83.)

.148 SAS No. 99 also includes an Exhibit, "Management Antifraud Programs and Controls: Guidance to Help Deter, Detect, and Prevent Fraud," which has been developed to assist auditors in obtaining an understanding of programs and controls established by management to mitigate specific risks of fraud, or that otherwise help to prevent, deter, and detect fraud. SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.

.149 The AICPA has published a fraud Practice Aid titled *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*. The Practice Aid includes topics such as how the new SAS changes audit practice, characteristics of fraud, understanding the new SAS, best practices, and practice aids, such as specialized industry fraud risk factors, common frauds, and extended audit procedures. Auditors should be on the lookout for this new publication.

Practice Aid *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*

.150 In connection with the issuance of SAS No. 99, the AICPA is issuing a Practice Aid to help practitioners implement the new fraud guidance. The practice aid is entitled *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide* (product no. 006613). The Practice Aid includes topics such as:

- How the new SAS changes audit practice
- Characteristics of fraud
- Understanding the new fraud SAS
- Best practices
- Practice aids, such as:
 - Specialized industry fraud risk factors
 - Common frauds and extended audit procedures

The Practice Aid represents valuable guidance in helping practitioners understand and implement SAS No. 99.

New Accounting Pronouncements and Other Guidance

.151 Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated with Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions, an amendment of FASB Statements No. 71 and 144 and FASB Interpretation No. 9</i>
FASB Interpretation No. 45	<i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i>
SOP 01-5	<i>Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</i>
SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i>
Technical Practice Aid	<i>Software Revenue Recognition</i>
Questions & Answers	<i>FASB Statement No. 87, Employers' Accounting for Pensions</i>

.152 The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org.

FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*

.153 This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*.

.154 The FASB decided to address the accounting and reporting for costs associated with exit or disposal activities because entities increasingly are engaging in exit and disposal activities and certain costs associated with those activities were recognized as liabilities at a plan (commitment) date under Issue No. 94-3 that did not meet the definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements*.

.155 The principal difference between this Statement and Issue No. 94-3 relates to the Statement's requirements for recognition of a liability for a cost associated with an exit or disposal activity. This Statement requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue No. 94-3, a liability for an exit cost as defined in Issue No. 94-3 was recognized at the date of an entity's commitment to an exit plan. A fundamental conclusion reached by the FASB in this Statement is that an entity's commitment to a plan, by itself, does not create a present obligation to others that meets the definition of a liability. Therefore, this Statement eliminates the definition and requirements for recognition of exit costs in Issue No. 94-3. This Statement also establishes that fair value is the objective for initial measurement of the liability.

.156 The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged.

On the Horizon

.157 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that may be relevant to your engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.158 The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Auditing Pipeline

New Framework for the Audit Process

.159 The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB issued an exposure draft in November 2002, which proposes to add or amend a number of auditing standards. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

.160 Some of the more important changes to the standards that are proposed are:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to assessment of the risk of material misstatement of the financial statements. Among other things, this will improve the auditor's assessment of inherent and control risks and eliminate the "default" to assess either of these risks at the maximum.
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit.
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures.

These changes collectively are intended to improve the guidance on how the auditor uses the audit risk model.

.161 In connection with this major initiative, the ASB and the International Auditing and Assurance Standards Board (IAASB) have formed a joint task force to develop joint standards addressing the risk assessment process. These standards will represent a significant step toward converging U.S. and international auditing standards.

.162 You should keep abreast of the status of this project and exposure draft, inasmuch as the proposed SASs will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Accounting Pipeline

Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment

.163 Proposed AICPA SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, and proposed FASB Statement of Financial Accounting Standards, *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment—an amendment of APB Opinions No. 20 and 28 and FASB Statements No. 51 and 67 and a rescission of FASB Statement No. 73*, are being issued simultaneously for public comment.

.164 Principally, the proposed FASB Statement would amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from its scope the accounting for acquisition, development, and construction costs of real estate developed and used by an entity for subsequent rental activities. The accounting for those costs would be subject to the guidance in the proposed SOP. It also would amend APB Opinion No. 28, *Interim Financial Reporting*, to require that those costs that the proposed SOP would require be expensed as incurred on an annual basis also be expensed as incurred in interim periods.

.165 The proposed SOP addresses accounting and disclosure issues related to determining which costs related to property, plant, and equipment should be capitalized as improvements and which should be charged to expense. The proposed SOP also addresses capitalization of indirect and overhead costs and component accounting for property, plant, and equipment. Final Statements are expected to be issued during the first half of 2003.

Exposure Draft on Liabilities and Equity

.166 The FASB has issued an exposure draft of a proposed Statement *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*. This proposed Statement would establish standards for issuers' classification in the statement of financial position of financial instruments with characteristics of liabilities, equity, or both. It would require that an issuer classify liability components and equity components of a financial instrument separately. This proposed Statement would prohibit the presentation of items between the liabilities section and the equity section of the statement of financial position. The FASB also issued an exposure draft of a proposed amendment, titled *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*, which would amend FASB Concepts Statement No. 6, *Elements of Financial Statements*. This proposed amendment to FASB Concepts Statement No. 6 would revise that definition to also include as liabilities certain obligations that require or permit settlement by issuance of the issuer's equity shares and that do not establish an ownership relationship. The objective of the project is to improve the transparency of the accounting for financial instruments that contain characteristics of liabilities, equity, or both. Final Statements are expected to be issued during the fourth quarter of 2002.

Resource Central

Educational courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

.167 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- Audit Guide *Consideration of Internal Control in a Financial Statement Audit* (product no. 012451kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit and Accounting Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012551kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2002* (product no. 009894kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide* (publication by the end of 2002)
- General Audit Risk Alert—2002/03 [AAM section 8010]
- Compilation and Review Alert *Compilation and Review Alert—2002/03* [AAM section 8015]
- Audit Risk Alert *E-Business Industry Developments—2002/03* [AAM section 8210]

Audit and Accounting Manual

.168 The *Audit and Accounting Manual* (product no. 005132kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditor's reports, checklists, and engagement letters; management representation letters; and confirmation letters.

AICPA reSOURCE Online: Accounting and Auditing Literature

.169 Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, all Audit and Accounting Guides, all Audit Risk Alerts, and *Accounting Trends & Techniques*. To subscribe to this essential online service, go to www.cpa2biz.com.

Educational Courses

.170 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (product no. 737082kk [VHS tape/manual] and 187082kk [video]). Whether you are in industry or public practice, this course keeps you current and informed, and shows you how to apply the most recent standards.
- *Fair Value Accounting for Hedge Transactions* (product no. 735182kk). This course helps you understand GAAP for derivatives and hedging activities. Also, you will learn how to identify effective and ineffective hedges.
- *Fraud and the Financial Statement Audit: Auditor Responsibilities Under New SAS* (product no. 731810kk [text] and 181810kk [video]; available December 31, 2002). The new fraud standard may not change your responsibilities for detecting fraud in a financial statement audit, but it will change how you meet that responsibility. Practitioners will benefit from a risk assessment approach to detecting fraud in a financial statement audit. You will learn the conceptual framework necessary to understand the characteristics of fraud.
- *Auditing for Internal Fraud* (product no. 730237kk). This course provides an auditor with the tools to identify fraud schemes. It trains CPAs to focus their analytical and substantive tests on the fraud triangle when evaluating internal controls. It also illustrates the latest in fraud prevention and detection programs implemented by industry leaders.

- *Identifying Fraudulent Financial Transactions* (product no. 730243kk). Learn to identify the red flags of fraud in financial information and to analyze a variety of fraud schemes. You will develop a framework for detecting financial statement fraud and learn about fraud schemes in revenue, inventory, liabilities, and assets.
- *Independence* (product no. 739058kk). This interactive CD-ROM course reviews the AICPA authoritative literature covering independence standards (including the newly issued SECPS independence requirements), SEC regulations on independence, and Independence Standards Board (ISB) standards.
- *SEC Reporting* (product no. 736747kk). This course helps the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.
- *E-Commerce: Controls and Audit* (product no. 731551kk). This course is a comprehensive overview of the world of e-commerce. Topics covered include internal control evaluation and audit procedures necessary for evaluating business-to-consumer and business-to-business transactions.

Online CPE

.171 The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee (\$95 for members and \$295 for nonmembers) provides unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

CPE CD-ROM

.172 *The Practitioner's Update* (product no. 738450kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

.173 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.174 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.175 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.

Web Sites

AICPA Online and CPA2Biz

.176 AICPA Online, at www.aicpa.org, offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the Professional Standards, and CPE courses.

Other Helpful Web Sites

.177 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of this Alert.

.178 This Audit Risk Alert replaces *High-Technology Industry Developments—2001/02*. *High-Technology 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 appreciated. You may e-mail these comments to ymishkevich@aicpa.org or write to:

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Information Sources

<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	www.aicpa.org
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
The Electronic Accountant	World Wide Web magazine that features up-to-the-minute news for accountants	www.electronicaccountant.com
AuditNet	Electronic communications among audit professionals	www.cowan.edu.au/mra/home.htm
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com/
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com/
Double Entries	A weekly newsletter on accounting and auditing around the world	www.csu.edu.au/lists.anet/ADBLE-L/index.html
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
Federal Reserve Bank of New York	Key interest rates	www.ny.frb.org/pihome/statistics/dlyrates
Cybersolve	Online financial calculators, such as ratio and breakeven analysis	www.cybersolve.com/tools1.html
FedWorld.Gov	U.S. Department of Commerce-sponsored site providing access to government publications	www.fedworld.com
Hoovers Online	Online information on various companies and industries	www.hoovers.com
Ask Jeeves	Search engine that uses a user-friendly question format. Provides simultaneous search results from other search engines as well (e.g., Excite, Yahoo, AltaVista)	www.askjeeves.com
Vision Project	Information on the profession's vision project	www.cpavision.org/horizon
Internet Bulletin for CPAs	CPA tool for Internet sites, discussion groups, and other resources for CPAs	www.kentis.com/ib.html
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org

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AAM Section 8140

Real Estate Industry Developments—2002/03

How This Alert Can Help You

.01 This Audit Risk Alert can help you plan and perform your real estate industry audits. The knowledge delivered by this Alert can provide assistance in achieving a more robust understanding of the business and economic environment in which your clients operate. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the real estate industry, and if you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert can assist you in making considerable strides in gaining that industry knowledge and understanding it.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

Industry and Economic Developments

The U.S. Economy

.04 As of the third quarter of 2002, anxious economists are downgrading their forecasts, and some crucial sectors of the economy are pushing the likelihood of a rebound into next year because of the abrupt slowdown in the economic recovery.

.05 For now, the overall economy is expanding, but sluggishly. Jobs are growing, but barely. And with a depressed stock market, concerns over a possible military action in Iraq, fears of terrorist strikes, and corporate scandals weighing on the national psyche, there is none of the exuberance that marked the recovery in the late 1990s.

.06 Analysts argue over whether the summer slump was just a pause in the rebound—perhaps as companies obsess about making sure their financial reports are accurate—or something more ominous. Even optimists say the chances of a double-dip recession—when a recession is followed by a short period of growth, only to be followed by another recession—once slim, are now up to 20 percent or more.

.07 The economy appears to be in a struggle between declining business confidence and strong consumer spending. Eventually, consumer demand should overcome business wariness, unless cautious businesses cut so many jobs that consumers finally give up. The same dynamic was at work during the fall of 2001. After September 11, the business sector froze, the consumer sector did not, and eventually consumer demand jump-started the economy.

.08 The underlying economic fundamentals remain relatively sound and point toward a moderate economic growth scenario. However, stock market weakness, coupled with recent data releases, has prompted downward forecast revisions.

Stock Market Woes

.09 Accounting scandals and corporate bankruptcies have generated tremendous investor uncertainty resulting in a dramatic decline in stock prices. While this is disconcerting, Wall Street scandals are not expected to play a *significant* adverse role on consumer spending or overall economic growth. Furthermore, any negative economic impacts generated by stock price declines are expected by economists to be constrained to third-quarter activity.

.10 Potentially, the decline in stock market prices can affect real economic activity by reducing consumer wealth and by adversely affecting consumer buying attitudes. Both conditions could reduce consumer spending activity.

.11 Stock prices have declined throughout 2002, resulting in a multitrillion dollar decline in wealth holdings. Most economists believe the decline in wealth will have a relatively small adverse impact on consumer spending. The wealth decline is primarily a temporary paper setback for investors. The underlying economic fundamentals are relatively sound and the profit picture facing corporate America is showing mixed signs of improvement. This suggests that once investors regain confidence in corporate financial reporting, the market will rebound strongly.

.12 Furthermore, the current environment of low interest rates and stock uncertainty has prompted additional support to real estate activity—providing additional support for real estate appreciation.

Current Monetary Policy

.13 In November 2002, for the first time in 11 months, the Federal Reserve Board lowered the federal funds rate to 1.25 percent, its lowest level in 41 years. At this point the Fed believes that the risks between inflation and very slow economic growth are balanced.

The Sarbanes-Oxley Act

.14 On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. The Act includes far-reaching changes in federal securities regulation that could represent the most significant overhaul since the enactment of the Securities Exchange Act of 1934. The Act prescribes a system of federal oversight of public auditors through a Public Company Accounting Oversight Board, a new set of auditor independence rules, new disclosure requirements applicable to public companies and insiders, and harsh civil and criminal penalties for persons who are responsible for accounting or reporting violations. The Act also imposes new restrictions on loans and stock transactions involving corporate insiders.

.15 A more complete summary of the Act is available on the AICPA Web site at www.aicpa.org/info/sarbanes_oxley_summary.htm and in the AICPA general *Audit Risk Alert* 2002/03.

General Industry Trends and Conditions

.16 Although the U.S. economy appears to point toward a moderate economic growth scenario, most sectors of real estate will continue to feel the pinch for the next 12 months, according to the Urban Land Institute's (ULI) mid-year Real Estate Forecast.

.17 With the exception of housing, real estate performance will likely lag behind the economy, the outlook says, cautioning that rising vacancies coupled with declines in commercial rents and property values have reduced profitability for many owners. Several ULI members provided industry insights for the report, which included a member survey.

.18 The forecast notes that recent encouraging economic news has led to predictions of a 4 percent growth rate in the U.S. gross domestic product by 2003. However, despite the likelihood of improvement for the

economy, commercial real estate is still reeling from the sharp economic downturn of last year. In particular, the lack of job growth has been the single most damaging factor affecting the industry, the study says.

.19 Only 49 percent of the respondents to ULI's forecast survey expect the profitability of real estate firms to be "good to excellent" through mid-2003, compared to 60 percent one year ago. In addition, 11 percent are expecting profitability to range between modestly poor and abysmal. The ULI forecast projects strongest profits among real estate services firms, followed by financial services/institutional investors, residential or resort developers, private real estate operating firms and developers, public real estate operating companies, and finally, real estate investment trusts.

.20 According to the forecast, development prospects will be strongest for housing in general. It ranks master-planned communities, middle-income detached housing, and infill housing as having the most potential. Urban mixed-use properties, mixed-use town centers, and attached housing are also expected to offer modestly good prospects. Offering the least potential are upscale/luxury hotels, followed by (in order) downtown office space, high-rise suburban office space, resort hotels, midprice and economy hotels, regional malls, and low-rise suburban office space.

.21 ULI survey participants voted Washington, D.C., as the "most favored" investment market, with New York, Los Angeles, Chicago, and San Diego rounding out the top five. The forecast comments that:

- Washington is "strong because of the tight market that predated the recession and the fact that demand remains strong in many sectors of the local economy, particularly government and defense contracting."
- New York suffered "the loss of the World Trade Center [which] has taken a lot of space out of the market and kept the market from deteriorating. . . . Infusion of state and federal funds to revitalize lower Manhattan will also help."
- Los Angeles "will lead because of its diversified economy—not heavily dependent on technology sectors—and its strong population growth."
- Chicago "will benefit from its broadly diversified economy and from recovery in the manufacturing sector."
- San Diego "will get a boost from increased defense spending."

.22 The retail sector appears the least affected by the weakened status for the commercial real estate industry, primarily because "the prospects for attractive rent increases were not particularly favorable last year and have not changed much since," the forecast says. The for-sale housing sector is expected to fare much better than the commercial side, with infill housing and middle-income detached homes experiencing fair to strong price increases. In general, consumer-driven real estate markets will fare better than business-driven markets over the coming year, the forecast concludes.

.23 In addition to forces in the general economy, other forces will continue to reshape the real estate industry, including the following:

- *Globalization.* Through consolidation and expansion, real estate companies are becoming international enterprises. Numerous opportunities for global expansion exist outside the United States, particularly in Europe and Asia. However, U.S. companies that expand overseas must be savvy about local conditions and must carefully assess the risks of doing business in an unfamiliar environment.
- *Larger real estate companies.* Traditionally, real estate companies tended to be privately held, entrepreneurial enterprises. This continues to change. Today, there are more than 150 public real estate companies. Recently, Standard & Poor's changed its policy and added several real estate investment trusts (REITs) to its indexes. In addition, primarily through mergers and acquisitions, larger real estate companies are continuing to emerge.

Larger public companies have different operating characteristics than smaller private companies. For example, larger public companies may have more comprehensive internal controls (including internal audit departments) and more sophisticated information technology (IT) to help them manage their real estate assets.

- *Technology.* Technology has played and will continue to play a significant role in reshaping the industry. The Internet has greatly enhanced the marketing of commercial property and facilitated the exchange of information about underlying industry conditions. The result has been a significant decrease in the time available to make real-estate-related decisions. In what had previously been a relatively slow-moving industry, the speed and availability of information made possible by new technology have increased the pace at which real estate business is conducted.

As a result of these recent trends, the real estate industry will endure significant and lasting change. The exact nature of these changes is still largely unknown; more time is needed to observe and analyze the interaction of these dynamics. This is still the embryonic stage of what is sometimes described as a revolution, but there is a consensus that the real estate industry is now more complex and sophisticated than ever before.

Industry Segment Conditions

Office Market Conditions

.24 The office market has fallen farther and faster than anyone thought possible a year ago. The vacancy rate, which reached a cyclical low point of 8.5 percent in the third quarter of 2000, rose to over 15 percent in 2002, well above the 10 percent rule of thumb that constitutes a balanced market.

.25 While tenants continued to vacate office space, the construction pipeline added 20.5 million square feet of competitive space (multitenant plus single tenant), a process that was initiated before the recession.

.26 The economy shows signs of recovery, but job growth is anemic, corporate earnings have been disappointing so far this year, and the recovery remains fragile. A sustained increase in business capital spending is required to power the expansion. As long as corporate earnings are poor, there isn't much to encourage capital spending, corporate hiring, or office leasing activity. Analysts are predicting the nation's vacancy rate to peak above 16 percent by the end of 2002 and then begin a moderate decline in 2003.

Industrial Market Conditions

.27 The industrial market is bottoming out, thanks to a decline in construction coupled with a slight pickup in demand. The vacancy rate is expected to peak at around 9 percent, far below the 13.7 percent peak that defined the bottom of the last recession 10 years ago. Small tenants and owner-users are leading the charge, while large companies remain paralyzed by earnings fears and the roller coaster stock market. The stabilizing industrial market disguises dramatic variations among different regions, some of which clearly remain in decline, while others are seeing a healthy pick up in demand.

.28 Nationally, the vacancy rate increased by less than one-tenth of 1 percent during the second quarter of 2002. By comparison, it had been rising by an average of 59 basis points per quarter over the prior five quarters. The five markets posting the sharpest vacancy declines were San Antonio, Orlando, Pittsburgh, Los Angeles, and Chicago. The five markets posting the sharpest increases were Des Moines, Phoenix, Boston, Sacramento, and Oakland.

.29 The improvement from recent quarters is due both to supply and demand factors. On the supply side, the amount of space under construction continues to fall. New space completions totaled 15 million square feet in the second quarter, half the quarterly average of 31 million square feet completed from 1999 through 2001. The amount of space still under construction totals 53 million square feet, well below half the 122 million square feet underway less than two years ago. On the demand side, the manufacturing sector of the economy continues to expand slowly even as the economy has lost momentum in recent weeks.

.30 The outlook for the industrial market depends entirely on the economy. Developers and lenders have cut back on construction. The economy is expanding, but not quickly enough to encourage hiring activity. Despite the moribund economy, the industrial market is moving into the recovery phase of the real estate cycle, but it is unlikely to bounce back quickly. Analysts expect the vacancy rate to begin a slow decline late this year, continuing into next year.

Retail Market Conditions

.31 Of all property types, retail probably has been the least affected by the recession. Retail sales are down and shopping center vacancy rates are up, but not to the extent of prior recessions. In fact, consumers have carried the economy through the recession. With the economy teetering on the brink of a deep recession after September 11, shoppers rushed to the malls and auto showrooms like it was their patriotic duty to spend the country out of recession. This was coupled with the fact that consumers had more money in their pockets due to low gas prices, tax rebate checks, low interest rates, and a rush of mortgage refinancing activity.

.32 The downside is that the rebound in retail sales and the retail property market is likely to be less robust than in prior recoveries. Several factors point to this soft rebound:

- Gas prices have risen steadily during the year.
- Home sales remain high, but may be poised for a fall. A decline in home sales would dampen sales at home furnishings and improvement stores.
- Mortgage refinancing may decline if interest rates begin to rise again.
- Joblessness continues to rise.

All of this means that retail sales will be weaker than usual following a recession, but most analysts expect moderate year-over-year gains, nevertheless.

.33 Market conditions vary widely by region. Several markets are seeing tight conditions, including Dallas, Los Angeles, and Silicon Valley, whereas other markets, such as Atlanta, Columbus, and Kansas City, are saturated. Most markets remain in balance, with new and expanding retailers replacing those who have closed or downsized.

Residential Market Conditions

.34 Unlike the broader economy, the single-family market showed no signs of recession in 2001 or 2002. Sales of new and existing homes reached record levels in 2002. With the Federal Reserve Board setting its benchmark for interest rates at its lowest level in 41 years, and with strong demographics, homebuilding has shrugged off stock market woes and growing unemployment to keep growing. Earlier forecast numbers for residential construction have now been revised upward. Housing starts were predicted to drop below 1.5 million for the year from 1.6 million in 2001, but they are now expected to finalize at 1.55 million starts for 2002.

.35 However, there are signs that the housing boom may be coming to an end. For the past several years, a rare confluence of factors—including low interest rates, low unemployment, easy credit standards, and tight housing supply—have combined to stimulate an unprecedented surge in home sales, sending prices rocketing up. The result: housing has been one of the most important bulwarks of the U.S. economy, even as it gets buffeted by plunging stocks, business scandals, and the war on terror. Now, however, some of the factors behind the housing boom show signs of fading, and indicators that traditionally foretell weakness in the market are emerging.

.36 In more than one hundred U.S. cities, home prices have climbed at least twice as fast as household incomes since 1998, according to data analyzed for the *Wall Street Journal* by the economic consulting firm Economy.com. Nationally, prices have risen at more than triple the rate of incomes in the last two years, a surge that is steadily putting home ownership out of the reach of more people. The nationwide price and income figures had tracked together closely through the 1990s boom.

.37 Though the problem is most common in the Northeast and on the West Coast, the list of localities with out-of-proportion prices includes large cities around the country such as Atlanta, Las Vegas, Denver, Houston, Tucson and Charleston, S.C. In Miami, home prices have shot up 58 percent since the beginning of 1998, while incomes have risen only 16 percent. In New York's Long Island suburbs, an 81 percent increase in home prices compares with a 14 percent rise in incomes. In Boston, home prices have jumped 89 percent, compared with income gains of only 22 percent.

.38 In some cities, including San Diego, Miami, and Washington, the run-ups have accelerated in the past year, confounding expectations that the market would cool off before it got too far out of line. In the late 1980s and early 1990s, the presence of such "bubblettes" in such places as Boston, Houston, and Los Angeles signaled the end of a boom cycle.

.39 On the multifamily side, building permits declined significantly during August, dropping 19 percent to 295,000 units permitted. On a year-over-year basis, multifamily permits fell more than 2 percent from 302,000 permits issued in August 2001.

.40 The most active states remained the same during the month of July. Four of the top five states witnessed an increase in permit levels in comparison to July 2001. On the upside were Florida, Texas, California, and New York, while activity in Georgia declined. Overall, these five states account for nearly 46 percent of total multifamily permit activity in the nation.

.41 The effect of the recent economic slowdown and low mortgage rates has been seen primarily within the nation's multifamily housing market. Starting midway through 2001, the apartment market saw steadily declining demand over a period of three quarters. As mounting job losses in some areas forced some households to relocate and falling mortgage rates spurred a new surge of first-time homebuyers, vacancies rose to a national average of 8.5 percent in the second quarter of 2002.

Hospitality Market Conditions

.42 Occupancies in the hospitality sector will suffer from a continued slowdown in corporate travel in 2002. The demand for lodging is being rocked by a variety of economic and security concerns, including the failure of the economy to strengthen to the extent most economists had forecast, the negative wealth effect from the sharp decline in stock values in throughout this year, the erosion in consumer confidence, increasing frustration with the inconvenience of air travel, and heightened fears of U.S. action against Iraq.

.43 The economy and the specific effects of the recent events will restrain lodging demand growth and encourage continued discounting through the end of 2002, according to PricewaterhouseCoopers. They are forecasting revenue per available room (RevPAR) to decline 2.3 percent this year. Without a catalyst for strong rebound in business travel in the short term, RevPAR will increase by only 3.5 percent in 2003. A more robust outlook is delayed to 2004, when RevPAR is expected to improve by 5.6 percent.

Real Estate Investment Trusts

.44 The prices for REIT shares bottomed out in late 1999 and have seen a major rebound throughout 2000, 2001, and 2002. Equity REITs, which make money by buying and then renting out offices, apartments, shopping malls, and other buildings, have posted a 55 percent cumulative total return since year-end 1999, according to the National Association of Real Estate Investment Trusts. Over the same stretch, the Standard & Poor's 500-stock index has slumped 35 percent. However, after two years of increases, returns on REITs fell 9 percent in the third quarter of 2002, according to Morgan Stanley.

.45 Green Street Advisors of Newport Beach, California, calculates the value of the real estate owned by REITs and then compares it with current REIT share prices. There has often been a yawning gap between these two numbers, with REIT shares selling at both steep discounts and steep premiums to this "net asset value." But over the past dozen years, REITs—on average—have traded at net asset value.

Environmental Factors Affecting Financial Reporting

Pressures to Perform

.46 Businesses deal with pressures that arise from a variety of sources, both internal and external. External pressures come primarily from the capital markets, with many believing that Wall Street's expectations too often drive inappropriate management behavior. Management often is under pressure to meet short-term performance indicators, such as earnings or revenue growth, financial ratios tied to debt covenants, or other measures. Most often the intentions of management are to follow sound and ethical practices, but pressure may build when analysts and shareholders demand short-term performance and when competitors move closer to the edge of the range of acceptable behavior.

.47 Members of top management also may be pressured to demonstrate that shareholder value has grown as a consequence of their leadership. Boards of directors often create pressure on management to meet financial and other goals. There also is a well-established practice of motivating management with stock options and other equity instruments that attempt to align management and shareholder interests. With their own performance and compensation tied to operating or financial targets, management can, in turn, push hard on personnel throughout the company, including those in operating business units, to meet what may be overly optimistic goals. This high-pressure environment can create an incentive to adopt practices that may be too aggressive or inconsistently applied in an effort to meet perceived expectations of the capital markets, creditors, or potential investors. At some point, the motivation behind earnings management can become strong enough for individuals with the right opportunity to move beyond acceptable practices, even though they are otherwise honest individuals. The greater the pressures, the more likely individuals will rationalize the acceptability of their actions.

Complexity and Sophistication of Business Structures and Transactions

.48 The increasing sophistication of the capital markets and the creativity of investment bankers and other financial advisers have fostered a wide variety of complex financial instruments and structured financial transactions. Many companies now use complex transactions involving transactions with one another in the form of purchases/sales of assets, derivative transactions, and intricate operating agreements designed to meet a specific reporting objective as well as an economic objective. Some companies have transferred assets off-balance-sheet or arranged for units to be acquired by special purpose entities, joint ventures, limited liability corporations, or partnerships, retaining substantially all the risks and rewards of ownership but without "control." Recent business failures, including the boom-bust cycle of dot-com enterprises, have focused attention on the potential risks of these business structures and transactions and the challenge of reporting them in a way that is easily understood by financial statement users.

.49 Many companies have adopted rapid and innovative forms of business expansion, either through acquisitions and mergers, or internal development. Such rapid expansion may have been necessary to support high price-to-earnings multiples. However, it also creates many challenges, including integrating disparate operations, melding internal control processes, and meeting expanded financing needs. Liquidity crises or financial reporting failures may result.

Current Audit and Accounting Issues

Assessing Audit Risks in the Current Environment

.50 The proper planning and execution of an audit has always required you to have a thorough understanding of the real estate industry and the nature of your client's business. For most audit firms, this in-depth understanding means that the most experienced partners and managers must become involved early and often in the audit process. In today's real estate environment, your judgment, knowledge, and experience are even more important than they were in the past.

.51 During the past year, the U.S. economy has suffered some significant declines: consumer confidence has dropped, plant closings and layoffs have increased dramatically, profit margins for many companies have slipped, and many companies have failed.

.52 Periods of economic uncertainty lead to challenging conditions for companies attributable to potential deterioration of operating results, increased external scrutiny, and reduced access to capital. During such times, professional skepticism should be heightened and the status quo should be challenged.

.53 More specifically, in today's economic environment, you should keep the following points in mind as you plan and perform audits of real estate clients.

- Understand how your client is affected by changes in the current business environment.
- Understand the stresses on your client's internal control over financial reporting, and how they may affect its effectiveness.
- Identify key risk areas, particularly those involving significant estimates and judgments.
- Approach the audit with objectivity and skepticism, notwithstanding prior experiences with or belief in management's integrity.
- Pay special attention to complex transactions, especially those presenting difficult issues of form versus substance.
- Consider whether additional specialized knowledge is needed on the audit team.
- Make management aware of identified audit differences on a timely basis.
- Question the unusual and challenge anything that doesn't make sense.
- Foster open, ongoing communications with management and the audit committee, including discussions about the quality of financial reporting and any pressure to accept less than high-quality financial reporting.
- When faced with a "gray" area, perform appropriate procedures to test and corroborate management's explanations and representations, and consult with others as needed.

Audit Planning

.54 As you prepare to conduct quarterly reviews and annual audits of real estate companies, you need to realize that your clients may be working in a new business environment as a result of the stagnant economy. If this is the case, you must gain an understanding of this new environment to adequately plan and perform the audit. Although not all real estate companies are directly affected by the economic downturn, most in the industry could experience some possible indirect effects. Many clients will experience effects related to shifts in demand, collectibility of accounts receivable, or valuation of their investments.

Evaluating Audit Risks

.55 We know that your evaluation of audit risk should start with a solid understanding of your client's business. To develop this understanding, you 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, you must be knowledgeable about property types and the location in which the entity operates.

.56 Audit risk can be altered when a real estate entity enters into new property types or new geographic markets. You should be aware that current economic conditions might force your real estate clients to expand

beyond their traditional sphere of operations. During audit planning, you should identify new property types or geographic locations and carefully assess the risks associated with the client's change in operating strategy.

Professional Skepticism

.57 The third general audit standard stipulates that due professional care be exercised in planning and conducting an audit engagement. Due professional care requires that you exercise professional skepticism in gathering and evaluating audit evidence. Although you neither assume that management is dishonest nor assume unquestioned honesty, you should consider the increased risk associated with the potential increases in external pressure faced by management during the current economic climate.

.58 As a result of perceived external pressures, companies may be tempted to manage earnings by using nonrecurring transactions or by changing the method of calculating key estimates, such as reserves, fair values, or impairments. Companies may also adopt inappropriate accounting practices resulting in improper recognition or omission of financial transactions. Material nonrecurring transactions may require special disclosure to facilitate the readers' understanding of the reported financial results, and the guidance in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, should be applied in reporting the effects of changes in estimates. Inappropriate transactions or accounting practices that may result in errors requiring adjustments of financial statements might include premature recognition of revenue, failure to appropriately accrue for contingent liabilities that are probable and estimable, and failure to record unpaid purchase invoices. Additionally, you should be particularly skeptical of fourth-quarter events that result in significant revenue recognition, loss accrual, or noncash earnings.

.59 The appropriate level of professional skepticism is needed when corroborating management's representations. Management's explanations should make business sense. Additionally, you may need to consider corroborating management's explanations with members of the board of directors or audit committee.

.60 Other indicators of potential increased accounting and reporting risk calling for increased professional skepticism include:

- Liquidity matters
 - The company is undercapitalized, is relying heavily on bank loans and other credit, and is in danger of violating loan covenants.
 - The company appears to be dependent on an initial public offering for future funding.
 - The company is having difficulty obtaining or maintaining financing.
 - The company is showing liquidity problems.
- Quality of earnings
 - The company is changing significant accounting policies and assumptions to less conservative ones.
 - The company is generating profits, but not cash flow.
- Management characteristics
 - Management's compensation is largely tied to earnings or the appreciation of stock options.
 - The company appears vulnerable to the weakening economic conditions, and management is not proactive in addressing changing conditions.
 - The company's management is selling its investment in company securities more than in the past.
 - There is a significant change in members of senior management or the board of directors.

Consideration of Fraud

.61 Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides the primary guidance on your responsibilities for detecting fraud-related misstatements when performing a financial statement audit.¹

.62 Some examples of fraud risk factors that may exist in real estate entities include the following:

- An excessive interest by management in maintaining or increasing the reported amount of real estate assets through the use of aggressive appraisal assumptions
- The use by management of unusually aggressive accounting practices in recognizing revenue from real estate sales
- Complicated criteria for recognizing sales transactions, making it difficult to assess the completion of the earnings process
- Inadequate responses or an unwillingness to respond to inquiries about known regulatory or legal issues, for example, the presence of environmental contamination on an entity-owned site
- Significant related-party transactions
- Significant side-agreements or transaction terms not previously disclosed
- Key contracts awarded without a competitive bidding process

The general state of the recent economy may raise several fraud risk factors. For example, management may be under significant pressure to obtain additional capital, or the entity may depend on debt with debt covenants that are difficult to maintain under the circumstances.

Auditing Estimates

.63 The real estate industry uses estimates in a variety of ways. 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.

.64 When auditing estimates, you should be familiar with SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342); the AICPA Practice Aid *Auditing Estimates and Other Soft Information*; and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

.65 Currently, certain segments of the real estate industry are in decline. 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. Be skeptical of cash flow and other performance projections that assume overly optimistic upward trends will occur.

.66 Pay close attention to the underlying assumptions used by management when auditing accounting estimates. Management is responsible for making the estimates included in the financial statements. Those estimates may be based in whole or in part on subjective factors, such as judgment based on experience with past as well as current events, and with conditions it expects to exist. You should be alert to the possibility of management's overreliance on economic information based on favorable conditions to predict future outcomes.

¹ Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), supersedes SAS No. 82, of the same name; amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230); and amends SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333). See the discussion of this new SAS in the "New Auditing and Attestation Pronouncements and Other Guidance" section later in this Alert.

Help Desk—Landauer Real Counselors publishes the annual *National Real Estate Market Forecast*, which can be downloaded at www.landauer.com. The report provides in-depth analysis of current industry conditions and the outlook for the future in five different property types. The publication provides one analysis of the conditions in major markets for each property type. The report is published annually.

Evaluating Going Concern

.67 The current business environment and market conditions might lead to rapidly deteriorating operating results and liquidity challenges for some real estate companies, particularly those with reduced access to capital. A company particularly sensitive to negative changes in economic conditions can rapidly develop a liquidity crisis and ultimately fail. Certain conditions, considered in the aggregate, may lead you to question the entity's ability to continue as a going concern. These include negative trends, such as recurring operating losses or working capital deficiencies, financial difficulties in the form of loan defaults or denial of credit from suppliers, dependence on the success of a particular product that is not selling well, legal proceedings, loss of a principal customer or supplier, destabilization of a trading partner or contract counterparty, and excessive reliance on external financing rather than funds generated from operations.

.68 Key in evaluating these risk factors is whether:

- Existing conditions and events can be mitigated by management's plans and their effective implementation.
- The company has the ability to control the implementation of mitigating plans rather than being dependent on actions of others.
- The company's assumption about its ability to continue as a going concern is based on realistic, rather than overly optimistic, assessments of its access to needed debt or equity capital or its ability to sell assets in a timely manner.
- Liquidity challenges have been appropriately satisfied and disclosed.

.69 When evaluating management's plans to continue as a going concern, an appropriate level of professional skepticism is important. For example, you may want to scrutinize the company's assumptions to continue as a going concern to assess whether those assumptions are based on overly optimistic or "once-in-a-lifetime" occurrences.

.70 Key factors in your evaluation of the ability to continue as a going concern are part of the guidance provided in 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).

Auditing in a Paperless Environment

.71 When clients rely on technology to manage and analyze information, audit strategies change. Consider the following examples:

- Audit evidence that previously existed in paper form may be available electronically only. Accessing electronic audit evidence may require you to become proficient in the use of data extraction or other audit software tools.
- The design and operation of internal control in a computer environment is much different than in a predominately manual environment.

.72 As real estate entities continue to expand their use of IT, you may need to become aware of the unique audit issues in a highly computerized environment. In addition, you should identify the risks of material misstatement that can arise during the transition from a highly manual environment to a more computerized operating environment.

.73 For further information and guidance on auditing in this paperless environment, see SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

Risks of Overseas Expansion

.74 According to a recent survey by DTZ International Property Advisers of Switzerland (DTZ), 70 percent of real estate investors hold overseas real estate assets. The survey questioned representatives from investment vehicles, institutions, and property companies and found that the majority of respondents go overseas to achieve superior returns. Europe emerges as their most popular investment target. The survey also reveals that this trend is set to continue, with 43 percent of respondents planning to increase overseas real estate investment in the short term; 60 percent plan to increase their overseas exposure within the next three to five years; and 57 percent plan to increase overseas activities over the longer term.

.75 When looking to buy overseas, the investors often cite economic performance, market size, and the tax and operating environment as key factors in identifying suitable markets. The lack of local market knowledge appears to be the major stumbling block. To overcome this challenge, the most popular method of entry into overseas markets is via joint ventures with local partners.

.76 Competing in foreign markets is complex and fraught with risks, many of which are indiscernible at first glance. The political risks in some nations are quite high, but even in countries that have relative political stability, complexities may arise. Each country has its own market characteristics, regulations and laws, and accounting standards. If your client has or is considering venturing into foreign real estate markets, you should gain an understanding of the risks of doing business in those markets. Consider whether the client has an effective process for identifying and managing those risks. For example, has management adequately assessed the realities of a foreign marketplace when developing assumptions about the future performance of real estate located in those markets?

Changes in Internal Control

.77 Large layoffs, staff reductions, and notifications to employees of impending termination can affect internal control over financial accounting and reporting systems. Remaining employees may feel overwhelmed by their workloads, lack of time to complete tasks and consider decisions, and simply be performing too many tasks and functions to meet the required levels of accuracy. In addition, rapid business expansion, changes in business strategies, and integration of different businesses may outstrip the ability of a company's financial systems to remain under effective internal control. Furthermore, controls at business units whose divestiture has been announced may be disrupted. As a result of any of these factors, internal control may become less effective or even ineffective.

.78 Relevant considerations are whether:

- The attention to internal control has been maintained in the face of significant changes in the business.
- As a result of unfilled positions, key control procedures are no longer being performed, are being performed less frequently, or are being performed by individuals lacking proper understanding to identify and correct errors.
- Layoffs of IT personnel have had a negative effect on the entity's ability to initiate, process, or record its transactions, or maintain the integrity of information generated by the IT system.
- Key functions that should be segregated are now being performed by one person.
- The impact of changes to the control environment has altered internal control effectiveness and potentially resulted in a material control weakness.
- Changes in internal control caused by past or pending layoffs or staff reductions create an opportunity for fraudulent activities, including misappropriation of assets.

Transactions Involving Off-Balance-Sheet Arrangements, Including Special Purpose Entities

.79 Some real estate entities make use of off-balance sheet arrangements to conduct financing or other business activities. These may involve unconsolidated, nonindependent, limited purpose entities, often referred to as structured finance or special purpose entities (SPEs). These entities may be used to provide financing, liquidity, or market risk or credit support, or may involve leasing, hedging, or research and development services. See the AICPA general *Audit Risk Alert—2002/03* for a detailed discussion about risks and audit procedures concerning this area.

Audit and Accounting Issues of Continuing Importance

Revenue Recognition

.80 During the past few years of industry recovery, many real estate entities were able to report impressive growth as a result of the improvement in the underlying real estate. But after suffering through last year's recession, some entities may be under increased pressure to maintain the previous rate of growth.

.81 You might want to consider the appropriateness of your client's revenue recognition policies or, especially, changes to those policies. Some clients attempt to demonstrate growth in a flattening market by changing operating or accounting policies that affect the timing or propriety of revenue recognition. In evaluating the revenue recognition policies of real estate entities, you should consider carefully whether the criteria in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 66, *Accounting for Sales of Real Estate*, have been met.

.82 You should also continue to be alert for the following:

- *"Put" arrangements.* These arrangements may commit a seller, its officers, or 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 a number of cases, put arrangements may not be formally documented, so you should consider the facts and circumstances surrounding property sales to be sure there are no formal or informal arrangements of this kind. You may also wish to request written representation from management regarding the absence of such agreements.
- *Direct or indirect seller financing.* Consider circumstances that would indicate that a seller might 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*.

.83 FASB Statement No. 66 describes examples of real estate transactions that include sales of corporate stock of enterprises with substantial real estate, partnership interests, and time-sharing interests. Questions have been raised about whether the sale of these investments should be accounted for under FASB Statement No. 66 or under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. In 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 is, in substance, real estate and should be accounted for in accordance with FASB Statement No. 66.

.84 FASB Interpretation No. 43, *Real Estate Sales*, clarifies that FASB Statement No. 66 applies to all real estate sales, not just those made by real estate entities. Included within the scope of FASB Statement No. 66 are sales of real estate with property improvements or integral equipment that cannot be removed and used separately from the real estate without incurring significant costs.

Lease Income

.85 Several accounting pronouncements provide guidance to lessors on recognizing lease revenue. These pronouncements include the following:

- *FASB Statement No. 13, Accounting for Leases*. Paragraph 19(b) of this Statement describes how a lessor should report lease income, as follows:
 - In general, rental income is recognized when it becomes receivable according to the provisions of the lease.
 - However, if the rentals vary from a straight-line basis, the income should be recognized on a straight-line basis (unless another systematic and rational basis is more representative of the time pattern in which use benefit from the lease property is diminished).
- *FASB Statement No. 29, Determining Contingent Rentals*. This statement defines contingent rentals and states that they should be recognized as revenue when they become accruable.
- *FASB Technical Bulletin No. 85-3, Accounting for Operating Leases with Scheduled Rent Increases*. This Technical Bulletin addresses whether it is appropriate for lessors to recognize scheduled rent increases on a basis other than as required in FASB Statement No. 13.
- *SEC Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition in Financial Statements*. SABs are not rules or interpretations of the SEC, but represent practices followed by SEC staff in administering the disclosure requirements of the federal securities laws. As clarified in Interpretive Response No. 8, a landlord should not recognize any contingent rental income until the threshold for contingent rental payments has passed.

.86 In auditing rental income, you should obtain reasonable assurance that rental income has been properly recognized during the period. Pay particular attention to revenue from contingent rentals and revenue recognition when lease payments are scheduled to vary from a straight-line basis.

.87 To properly recognize rental income on a straight-line basis, the accounting for income from lease arrangements that call for scheduled rent increases requires the recording of a receivable during the early years of the lease. If your client's financial statements include such a receivable, you should determine that it is collectible, for example, by assessing the creditworthiness of the tenant.

Help Desk—Auditors designing and performing procedures related to revenue recognition can look to the AICPA publication *Auditing Revenue in Certain Industries* (product no. 012510kk).

Sale-Leaseback Transactions

.88 Industry observers continue to report a growing number of sale-leaseback transactions involving corporations that own their facilities. Real estate entities may participate in these transactions as the purchaser-lessor.

.89 FASB Statement No. 13 describes the accounting by the purchaser-lessor in a sale-leaseback transaction, as follows:

- If the lease meets the criteria for classification as a capital lease, the purchaser-lessor should record the transaction as a purchase and a direct financing lease.
- If the lease does not meet the criteria for classification as a capital lease, the purchaser-lessor should record the transaction as a purchase and an operating lease.

.90 You can find the primary guidance on accounting by the seller-lessee in a sale-leaseback transaction in FASB Statement No. 98, *Accounting for Leases*.

Asset Impairment

.91 Specific markets or properties in the real estate industry may not weather last year's recession well. For that reason, you should continue to be alert for the possible impairment of real estate assets.

.92 FASB recently issued a Statement that provides the primary guidance on accounting for the impairment of real estate assets.

.93 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. FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, does not provide exceptions for assets subject to nonrecourse debt.

Real Estate Properties Held for Investment

.94 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 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 recover the carrying amount of the investment fully.
- 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 to rent property.
- Properties held for sale remain unsold at subsequent balance-sheet dates.
- Other investors have decided to cease providing support or 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 that is modified for a departure from GAAP attributable to the improper valuation of assets).

.95 If events and 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 recognizing an impairment, the entity should account for the reduced carrying amount of the asset as the new cost of the asset and depreciate it over the remaining useful life. Restoration of previously recognized impairment losses is prohibited.

.96 Lack of an asset-impairment evaluation system may indicate a material weakness in an entity's internal controls. Further, a lack of documentation generally increases the extent to which you must apply professional judgment in evaluating the adequacy of management's write-downs.

Real Estate to Be Disposed of by Sale

.97 Real estate to be disposed of by sale (real estate for which management has committed to a plan of disposal by sale) should be reported at the lower of the 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. Nevertheless, 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*.

.98 Some real estate might have previously been subject to APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. FASB Statement No. 144 amended APB Opinion No. 30. The provisions of FASB Statement No. 144 apply to all long-lived assets. Therefore, gains or losses on a disposal of a discontinued operation are no longer measured on a net realizable value basis, and future operating losses are no longer recognized before they occur.

Assets to Be Disposed of Other Than by Sale

.99 Assets that are to be abandoned, exchanged for a similar productive asset, or distributed to owners in a spinoff are to be considered as held and used until they are disposed of. If the asset is to be abandoned, the depreciable life is revised in accordance with APB Opinion No. 20, *Accounting Changes*. If the asset is to be exchanged for a similar productive asset or distributed to owners in a spinoff and if the carrying amount of the asset exceeds its fair value at the date of exchange or distribution, an impairment loss is to be recognized at that date.

Non-GAAP Measures of Performance

.100 In 1999, the National Association of Real Estate Investment Trusts (NAREIT) issued recommendations with respect to clarifying the industry's supplemental performance benchmark, called Funds From Operations (FFO). These recommendations include the following:

- The industry's supplemental performance measure should include all operating results, both recurring and nonrecurring, except those results defined as "extraordinary items" under GAAP and gains and losses from sales of depreciable operating property.
- The industry's supplemental performance measure should continue to be labeled "Funds From Operations."
- The clarification of FFO is effective January 1, 2000.
- Calculation of FFO based on this clarification should be shown for all periods presented in financial statements or tables.
- Disclosures should include the information included in the NAREIT white paper on FFO and in NAREIT National Policy Bulletins related to reporting FFO.

These recommendations were based on a year-long evaluation of the industry's supplemental performance benchmark at the direction of NAREIT's leadership. NAREIT surveyed member company executives, investment analysts, institutional investors, and other industry participants regarding the effectiveness of FFO.

.101 However, the SEC staff has noted that FFO has been discussed outside of the financial statements in several recent filings with the SEC. Neither GAAP nor SEC authoritative accounting literature provides a definition of FFO, and the SEC staff's views on the presentation of supplemental earnings measures and cash-flow measures as a proxy for net income and the presentation of funds generated from operations are expressed in Accounting Series Release (ASR) No. 142 (Section 202 of SEC's *Financial Reporting Policies*). ASR No. 142 states that if such measurements of economic performance are presented in the MD&A section or elsewhere, they should not be presented in such 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 primary measure of operating performance for the REIT or an appropriate measure for which dividends are computed and based. In addition, ASR No. 142 does not allow these supplemental earnings or cash-flow measures to be reported on a per-share basis. Net income and cash flows from operating, investing, and financing activities remain the appropriate measures.

Effect of FASB Statement No. 144 on FFO

.102 After considering the impact of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, on income statements prepared using GAAP and on FFO, NAREIT's board of governors adopted several recommendations of the Association's Best Financial Practices Council. Chief among them is affirmation of NAREIT's commitment to GAAP net income as the primary industry earnings measure.

.103 The board of governors also adopted a recommendation that FFO from income-producing property held for sale, sold, or otherwise transferred and now reported in "results of discontinued operations" should be included in consolidated FFO.

.104 The resulting clarification of NAREIT's white paper on FFO was needed to ensure that a change in GAAP classification made by FASB Statement No. 144 did not create an inappropriate and unintended change in reported FFO. The clarification results in no change to FFO—mirroring the impact of FASB Statement No. 144 on GAAP net income.

New Auditing and Attestation Pronouncements and Other Guidance

.105 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 95	<i>Generally Accepted Auditing Standards</i>
SAS No. 96	<i>Audit Documentation</i>
SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i>
SAS No. 100	<i>Interim Financial Information</i>
SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>
SSAE No. 11	<i>Attest Documentation</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i>
SQCS No. 6	<i>Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>
Audit Guide	<i>Service Organizations: Applying SAS No. 70, as Amended</i>
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i>
Auditing Interpretation No. 4 of SAS No. 70	"Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls"
Auditing Interpretation No. 5 of SAS No. 70	"Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods"

Auditing Interpretation No. 14 of SAS No. 58	"Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing"
Auditing Interpretation No. 12 of SAS No. 1, section 420	"The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Change in the Year of Adoption"
Auditing Interpretation No. 15 of SAS No. 58	"Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations"
Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Practice Alert No. 02-1	<i>Communications With the Securities and Exchange Commission</i>
Practice Alert No. 02-2	<i>Use of Specialists</i>
Practice Alert No. 02-3	<i>Reauditing Financial Statements</i>
Practice Aid	<i>Fraud Detection in a GAAS Audit</i>
Practice Aid	<i>New Standards, New Services: Implementing the Attestation Standards</i>
Practice Aid	<i>Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users</i>

.106 The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*

.107 SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, supersedes Statement on Auditing Standards No. 82, *Consideration of Fraud in a Financial Statement Audit* (AU sec. 316); amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230); and amends SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), as amended. The Statement does not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1 (AU sec. 110.02).² However, SAS No. 99 establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with generally accepted auditing standards (GAAS).³

² The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). 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 (see SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 312]), or fraud.

³ Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statement in accordance with generally accepted auditing standards. Chapter 1, "Attest Engagements," of Statement on Standards for Attestation Engagements No. 10, *Attestation Standards. Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101), and Statement on Standards for Consulting Services (AICPA, *Professional Standards*, vol. 2, CS sec. 100) provide guidance to accountants relating to the performance of such services.

.108 The following is an overview of the content of the SAS No. 99, with references to paragraphs in the new fraud standard:

- *Description and characteristics of fraud.* This section describes fraud and its characteristics. (See paragraphs 5 through 12.)
- *The importance of exercising professional skepticism.* This section discusses the need for auditors to exercise professional skepticism when considering the possibility that a material misstatement due to fraud could be present. (See paragraph 13.)
- *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.* This section requires, as part of planning the audit, that there be a discussion among the audit team members to consider how and where the entity's financial statements might be susceptible to material misstatement due to fraud and to reinforce the importance of adopting an appropriate mindset of professional skepticism. (See paragraphs 14 through 18.)
- *Obtaining the information needed to identify risks of material misstatement due to fraud.* This section requires the auditor to gather information necessary to identify risks of material misstatement due to fraud, by:
 1. Inquiring of management and others within the entity about the risks of fraud. (See paragraphs 20 through 27.)
 2. Considering the results of the analytical procedures performed in planning the audit. (See paragraphs 28 through 30.)
 3. Considering fraud risk factors. (See paragraphs 31 through 33, and the appendix, "Examples of Fraud Risk Factors.")
 4. Considering certain other information. (See paragraph 34.)
- *Identifying risks that may result in a material misstatement due to fraud.* This section requires the auditor to use the information gathered to identify risks that may result in a material misstatement due to fraud. (See paragraphs 35 through 42.)
- *Assessing the identified risks after taking into account an evaluation of the entity's programs and controls.* This section requires the auditor to evaluate the entity's programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation. (See paragraphs 43 through 45.)
- *Responding to the results of the assessment.* This section emphasizes that the auditor's response to the risks of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence (see paragraph 46). The section requires the auditor to respond to the results of the risk assessment in three ways:
 1. A response that has an overall effect on how the audit is conducted, that is, a response involving more general considerations apart from the specific procedures otherwise planned (See paragraph 50.)
 2. A response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed (See paragraphs 51 through 56.)
 3. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls (See paragraphs 57 through 67.)
- *Evaluating audit evidence.* This section requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate at the completion of the audit whether the accumulated results of auditing procedures and other observations affect the assessment. (See paragraphs 68 through 74.) It also requires the auditor to consider whether identified misstatements may be indicative of fraud and, if so, directs the auditor to evaluate their implications. (See paragraphs 75 through 78.)

- *Communicating about fraud to management, the audit committee, and others.* This section provides guidance regarding the auditor's communications about fraud to management, the audit committee, and others. (See paragraphs 79 through 82.)
- *Documenting the auditor's consideration of fraud.* This section describes related documentation requirements. (See paragraph 83.)

.109 SAS No. 99 also includes an exhibit, "Management Antifraud Programs and Controls: Guidance to Help Deter, Detect, and Prevent Fraud," which has been developed to assist auditors in obtaining an understanding of programs and controls established by management to mitigate specific risks of fraud, or that otherwise help to prevent, deter, and detect fraud. SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.

.110 The AICPA has developed a Practice Aid titled *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide*, which will be published by the end of 2002. The Practice Aid includes topics such as how the new SAS changes audit practice, characteristics of fraud, understanding the new SAS, best practices, and practice aids such as, specialized industry fraud risk factors, common frauds, and extended audit procedures. Auditors should be on the lookout for this new publication (see the section titled "Practice Aid *Fraud Detection in a GAAS Audit*" later in this Alert for more information).

Practice Alert 02-2, *Use of Specialists*

.111 The AICPA Securities and Exchange Commission Practice Section (SECPS) Executive Committee established a Professional Issues Task Force (PITF), which formulates guidance based on issues arising in peer reviews, firm inspections, and litigation to facilitate the resolution of emerging audit practice issues. This guidance takes the form of Practice Alerts. The information contained in these Practice Alerts is nonauthoritative. It represents the views of the members of the PITF and does not represent official positions of the AICPA.

.112 Auditors may encounter difficulty in determining the appropriate situations in which to use a specialist and, in those cases when a specialist is appropriately used, understanding the findings of the specialist. The current guidance when specialists are used is broad and focuses on the use of all kinds of specialists. The purpose of Practice Alert 02-2 is to assist auditors in understanding their responsibilities with respect to both the use of specialists that have been engaged or employed by the audit client and the use of specialists engaged or employed by the audit firm.

Practice Aid *Fraud Detection in a GAAS Audit*

.113 In connection with the issuance of SAS No. 99, the AICPA has developed a Practice Aid to help practitioners implement the new fraud guidance. The practice aid is entitled *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (product no. 006613) and will be available in December 2002. The Practice Aid includes topics such as:

- How the new SAS changes audit practice
- Characteristics of fraud
- Understanding the new fraud SAS
- Best practices
- Practice aids, such as:
 - Specialized industry fraud risk factors
 - Common frauds and extended audit procedures

The Practice Aid represents valuable guidance in helping practitioners understand and implement SAS No. 99.

New Accounting Pronouncements and Other Guidance

.114 Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated with Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions, an amendment of FASB Statements No. 71 and 144 and FASB Interpretation No. 9</i>
SOP 01-5	<i>Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</i>
SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i>
Technical Practice Aid	<i>Software Revenue Recognition</i>
Questions & Answers	<i>FASB Statement No. 87, Employers' Accounting for Pensions</i>

.115 The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org.

FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*

.116 In April 2002, the FASB issued FASB Statement No. 145, which rescinds FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, and an amendment of that Statement, FASB Statement No. 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements*, thereby eliminating the requirement that gains and losses from debt extinguishments be classified as extraordinary items. Instead, those entities should use the provisions of APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, as amended and interpreted, to report debt extinguishments in fiscal years beginning after May 15, 2002, with earlier application encouraged. Other effective dates apply to the other provisions of FASB Statement No. 145. This Statement also rescinds FASB Statement No. 44, *Accounting for Intangible Assets of Motor Carriers*. This Statement amends FASB Statement No. 13, *Accounting for Leases*, as well, to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. This Statement also amends other existing authoritative pronouncements to make various technical corrections, clarify meanings, or describe their applicability under changing conditions.

.117 The provisions of this Statement related to the rescission of FASB Statement No. 4 should be applied in fiscal years beginning after May 15, 2002. Any gain or loss on extinguishment of debt that was classified as an extraordinary item in prior periods presented that does not meet the criteria in APB Opinion No. 30 for classification as an extraordinary item should be reclassified. Early application of the provisions of this Statement related to the rescission of FASB Statement No. 4 is encouraged.

.118 The provisions in paragraphs 8 and 9(c) of this Statement related to FASB Statement No. 13 should be for transactions occurring after May 15, 2002, with early application encouraged. All other provisions of this Statement shall be effective for financial statements issued on or after May 15, 2002, with early application encouraged.

.119 Early application of the provisions of this Statement may be as of the beginning of the fiscal year or as of the beginning of the interim period in which this Statement is issued.

On the Horizon

.120 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that may be relevant to your engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.121 The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	http://www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Auditing Pipeline

Exposure Draft on Auditing Fair Value Measurements and Disclosures

.122 The AICPA's Auditing Standards Board (ASB) has issued an exposure draft of a proposed SAS titled *Auditing Fair Value Measurements and Disclosures*. The proposed SAS addresses auditing considerations relating to measurement, presentation, and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. A vote to ballot a document for final issuance is expected to occur in December 2002.

New Framework for the Audit Process

.123 The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB expects to issue a series of exposure drafts in before the end of 2002. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

.124 Some of the more important changes to the standards that are expected to be proposed are:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to assessment of the risk of material misstatement of the financial statements. Among other things, this will improve the auditor's assessment of inherent and control risks and eliminate the "default" to assess either of these risks at the maximum.
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit.
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures.

These changes collectively are intended to improve the guidance on how the auditor uses the audit risk model.

.125 In connection with this major initiative, the ASB and the International Auditing and Assurance Standards Board (IAASB) have agreed to form a joint task force to develop joint standards addressing the risk assessment process. These standards will represent a significant step toward converging U.S. and international auditing standards. These proposed standards are being exposed now.

.126 You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Accounting Pipeline

Consolidation of Certain Special-Purpose Entities

.127 The FASB has issued an exposure draft of a proposed Interpretation, *Consolidation of Certain Special-Purpose Entities*, of ARB No. 51, *Consolidated Financial Statements*. This proposed Interpretation would address consolidation by business enterprises of SPEs to which the usual condition of consolidation described in Accounting Research Bulletin No. 51 does not apply because the SPEs have no voting interest or otherwise are not subject to control through ownership of voting interests. A final Statement is expected to be issued during the fourth quarter of 2002.

Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment

.128 Proposed AICPA SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, and proposed FASB Statement, *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment—an amendment of APB Opinions No. 20 and 28 and FASB Statements No. 51 and 67 and a rescission of FASB Statement No. 73*, are being issued simultaneously for public comment.

.129 Principally, the proposed FASB Statement would amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from its scope the accounting for acquisition, development, and construction costs of real estate developed and used by an entity for subsequent rental activities. The accounting for those costs would be subject to the guidance in the proposed SOP. It also would amend APB Opinion No. 28, *Interim Financial Reporting*, to require that those costs that the proposed SOP would require be expensed as incurred on an annual basis also be expensed as incurred in interim periods.

.130 The proposed SOP addresses accounting and disclosure issues related to determining which costs related to property, plant, and equipment should be capitalized as improvements and which should be

charged to expense. The proposed SOP also addresses capitalization of indirect and overhead costs and component accounting for property, plant, and equipment. Final Statements are expected to be issued during the first half of 2003.

Proposed AICPA SOP Related to Real Estate Time-Sharing Transactions

.131 This proposed SOP will address several key issues affecting the sellers of real estate time-sharing arrangements. These issues include revenue recognition, determining the allowance for uncollectible receivables, and the deferring of selling costs. At its September 2001 meeting, the Accounting Standards Executive Committee (AcSEC) approved for exposure, subject to AcSEC's positive clearance of certain revisions and FASB clearance, a draft SOP titled *Accounting for Real Estate Time-Sharing Transactions*. AcSEC expects to issue the exposure draft in the first quarter of 2003.

.132 Tentative conclusions to date include the following:

- *Basic accounting model.* The underlying structural basis for the time-sharing model is the retail land sales model of FASB Statement No. 66, with inclusion of certain of the fundamental principles of the other-than-retail-land-sales model of that Statement.
- *Basic accounting model—Buyer's commitment test.* The accounting model's test for buyer's commitment is a 10 percent-of-principle test, similar to that of the FASB Statement No. 66 retail land sales model, which would be met by receipt by the seller of cumulative down payments of at least 10 percent of the sales price.
- *Basic accounting model—Collectibility-of-receivables test.* Collectibility is demonstrated either by meeting a test based on collection of 85 percent of prior similar projects' receivables dollars or by the seller's collection of cumulative principle payments of at least 25 percent of the sales price.
- *Basic accounting model—Estimability-of-credit-losses test.* The estimability-of-credit-losses test is a nonbright-line test, subject to certain criteria, whereby a time-sharing entity would have to have sufficient collection experience to demonstrate that it can reliably measure credit losses (analogous to the ability to estimate future returns discussed in FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*).
- *Meaning of credit losses.* For purposes of estimating credit losses in the collectibility-of-receivables and estimability-of-credit-losses tests, sales canceled subsequent to being recorded as sales should be considered credit losses, rather than sales reversals. A seller should interpret credit losses broadly to include all situations in which, as a result of credit concerns, less than 100 percent of a receivable is collected from a buyer. Costs related to credit losses (for example, collection costs) should not be incorporated into the seller's estimate of credit losses but should instead be charged to selling, general, and administrative expense as incurred.
- *Accounting for estimated and actual credit losses.* For sales (meeting the recognition criteria) that, based on historical and statistical information, are not expected to be collected, revenue should be reduced rather than bad debt expense charged.
- *Accounting for cost of sales and inventory.* The relative sales value method should be used to allocate inventory cost and determine the cost of sales when inventory relief is recorded as part of a sale.
- *Passage-of-title requirement.* Passage of nonreversionary title is a criterion for treating a time-sharing transaction as a sale rather than a lease.
- *Rentals of unsold interests.* Rentals are considered to be holding-period activities and are accounted for as "incidental operations." Incidental operations would be defined as in FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, except that the SOP's definition would not require that the purposes of those operations is to reduce the cost of developing the property for its intended use. Time-sharing interests should be accounted for as inventory rather than fixed assets, and therefore not be depreciated during times of rental.

- *Expensing versus deferral of selling costs.* Selling costs should be accounted for using the “directly associated” approach of paragraph 18 of FASB Statement No. 67, modified to include some restrictions similar to those in FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*.
- *Special purpose entities.* The issue involves SPE structures in which a seller transfers deeded title to a trust or third party (the SPE) in exchange for stock or other interests in the SPE, which the seller then sells to the time-share buyers. Sales should be recorded only upon the sale of the stock or interests to the time-share buyer, not upon transfer of title to the SPE. Generally, an SPE should be viewed as an entity lacking economic substance and established to facilitate sales. The seller should present in its balance sheet the unsold interests in the SPE as time-share inventory rather than apply consolidation or some other accounting method to the seller’s interests in the SPE as the seller’s ownership percentage in the SPE decreases during the sellout of a project.
- *Amendments to Level A GAAP.* If the final SOP is issued, the FASB would remove from FASB Statement No. 66 the guidance related to time-sharing; that Statement would direct the reader to the SOP for guidance. The FASB would also modify FASB Statement No. 67 to exclude time-sharing transactions from the section in the Statement titled “Costs Incurred to Sell Real Estate Projects,” in view of the SOP’s prescribed “incremental” accounting for time-sharing selling costs.

Resource Central

Educational courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

.133 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- Audit and Accounting Guide *Common Interest Realty Associations* 2002 (product no. 012572kk)
- Audit and Accounting Guide *Construction Contractors* 2002 (product no. 012582kk)
- Audit and Accounting Guide *Guide for the Use of Real Estate Appraisal Information* (product no. 013159kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit and Accounting Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012551kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2002*
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide* (publication by the end of 2002)
- General Audit Risk Alert—2002/03 [AAM section 8010]
- Compilation and Review Alert *Compilation and Review Alert—2002/03* [AAM section 8015]

- Audit Risk Alert *Construction Contractors Industry Developments*—2002/03 [AAM section 8090]
- Audit Risk Alert *Common Interest Realty Associations Industry Developments*—2002/03 [AAM section 8080]
- Audit Risk Alert *E-Business Industry Developments*—2002/03 [AAM section 8210]

Audit and Accounting Manual

.134 The *Audit and Accounting Manual* (product no. 005132kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditor's reports, checklists, and engagement letters; management representation letters; and confirmation letters.

AICPA reSOURCE Online: Accounting and Auditing Literature

.135 Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, all Audit and Accounting Guides, all Audit Risk Alerts, and *Accounting Trends & Techniques*. To subscribe to this essential online service, go to cpa2biz.com.

Educational Courses

.136 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (product no. 737082kk (VHS tape/manual) and 187082kk (video)). Whether you are in industry or public practice, this course keeps you current and informed, and shows you how to apply the most recent standards.
- *Fair Value Accounting for Hedge Transactions* (product no. 735182kk). This course helps you understand GAAP for derivatives and hedging activities. Also, you will learn how to identify effective and ineffective hedges.
- *Fraud and the Financial Statement Audit: Auditor Responsibilities Under New SAS* (product no. 731810kk (text) and 181810kk (video); available December 31, 2002). The new fraud standard may not change your responsibilities for detecting fraud in a financial statement audit, but it will change how you meet that responsibility. Practitioners will benefit from a risk assessment approach to detecting fraud in a financial statement audit. You will learn the conceptual framework necessary to understand the characteristics of fraud.
- *Auditing for Internal Fraud* (product no. 730237kk). This course provides an auditor with the tools to identify fraud schemes. It trains CPAs to focus their analytical and substantive tests on the fraud triangle when evaluating internal controls. It also illustrates the latest in fraud prevention and detection programs implemented by industry leaders.
- *Identifying Fraudulent Financial Transactions* (product no. 730243kk). Learn to identify the red flags of fraud in financial information and to analyze a variety of fraud schemes. You will develop a framework for detecting financial statement fraud and learn about fraud schemes in revenue, inventory, liabilities, and assets.
- *Independence* (product no. 739058kk). This interactive CD-ROM course reviews the AICPA authoritative literature covering independence standards (including the newly issued SECPS independence requirements), SEC regulations on independence, and Independence Standards Board (ISB) standards.
- *SEC Reporting* (product no. 736747kk). This course helps the practicing CPA and corporate financial officer learn to apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.

- *E-Commerce: Controls and Audit* (product no. 731551kk). This course is a comprehensive overview of the world of e-commerce. Topics covered include internal control evaluation and audit procedures necessary for evaluating business-to-consumer and business-to-business transactions.

In addition to the general courses mentioned here, the following courses might be relevant to practitioners with real estate clients:

- Self-study—*Real Estate Accounting and Auditing*, by Michael Ramos (product no. 730599kk)
- Group study—*Real Estate Accounting and Auditing* (product no. 730600kk). This course is also available for in-firm delivery.

Online CPE

.137 The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee (\$95 for members and \$295 for nonmembers) provides unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

CPE CD-ROM

.138 *The Practitioner's Update* (product no. 738450kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Real Estate Annual Conference

.139 The AICPA sponsors an annual Real Estate Conference in the fall. For further information about the conference, contact the Member Satisfaction Team at (888) 777-7077 or visit the CPA2Biz Web site (cpa2biz.com) to view the latest conferences calendar and to register.

Member Satisfaction Center

.140 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.141 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.142 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.

Web Sites

AICPA Online and CPA2Biz

.143 AICPA Online, at www.aicpa.org, offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing

world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the professional standards, and CPE courses.

Other Helpful Web Sites

.144 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of this Alert.

.145 This Audit Risk Alert replaces *Real Estate Industry Developments—2001/02*. *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 those with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to ymishkevich@aicpa.org or write to:

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Appendix

The Internet—An Auditor's Research Tool

Here are some general Web sites that you may find useful to your practice:

<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	www.aicpa.org
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
Securities and Exchange Commission	The SEC Digest and Statements, EDGAR database, current SEC rulemaking	www.sec.gov
FASAB	Federal Accounting Standards Board	www.financenet.gov/fasab.htm
U.S. Federal Government Agencies Directory	A list of all federal agencies on the Internet	www.lib.lsu.edu/gov/fedgov.html
The Electronic Accountant	World Wide Web magazine that features up-to-the-minute news for accountants	www.electronicaccountant.com
CPAnet	Online community and resource center	www.cpalinks.com/
Guide to WWW for Research and Auditing	Basic instructions on how to use the Web as an auditing research tool	www.tetranet.net/users/gaostl/guide.htm
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com/
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
Federal Reserve Bank of New York	Key interest rates	www.ny.frb.org/pihome/statistics/dlyrates
FirstGov	Portal through which all government agencies can be accessed	www.firstgov.gov
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
International Federation of Accountants	Information on standards-setting activities in the international arena	www.ifac.org
Hoovers Online	Online information on various companies and industries	www.hoovers.com
Ask Jeeves	Search engine that uses a user-friendly question format and provides simultaneous search results from other search engines as well (for example, Excite, Yahoo, and AltaVista)	www.askjeeves.com

In addition to the general information provided above, the Internet covers a vast amount of information that may be valuable to auditors of real estate entities, including the following:

- Market forecasts and analyses by city and property type
- Discussions of current industry trends
- Benchmarking studies and comparative financial and nonfinancial data, for example, capitalization rates, occupancy statistics, and planned future development
- Articles and press releases relating to current industry items of interest
- Links to other real estate Internet sites

Some of the more relevant sites for those of you with real estate clients could include those shown in the following table:

<i>Organization</i>	<i>Internet Address</i>
Building Owners and Managers Association	www.boma.org
Commercial Investment Real Estate Network	www.ccim.com
Institute of Real Estate Management	www.irem.org
National Association of Real Estate Investment Trusts	www.nareit.org
National Council of Real Estate Investment Fiduciaries	www.ncreif.org
Real Estate Investment Advisory Council	www.reiac.org
American Resort Development Association	www.arda.org
Society of Industrial and Office Realtors	www.sior.com

The real estate practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to practitioners.

[The next page is 8521.]

AAM Section 8150

Retail Industry Developments—2001/02

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your retail industry audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the retail industry, and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2001/02* [AAM section 8010].

Economic and Industry Developments

What are the current economic and industry conditions facing retailers this year?

.03 For a complete overview of the current economic environment in the United States see the AICPA general *Audit Risk Alert—2001/02* [AAM section 8010].

.04 The Christmas shopping season, of crucial importance to retailers, netted dismal results for 2000. The poor holiday season showing led to reduced profits early in 2001 as retailers were forced to offer steep discounts to move unsold inventories. High levels of promotional activities have accompanied the product discount programs. In light of these advertising activities, discounts, and other incentives, auditors may need to consider whether their clients have properly addressed the accounting and disclosure issues relating to these matters. The accounting treatment for advertising costs and incentives is addressed in the “Accounting for Advertising Costs” and “Special Customer Programs” sections of this Alert.

.05 As the third quarter of 2001 passed, retailers continued to post losses and those retailers reporting profits were fewer than expected. Consumers are frequenting discount stores and warehouse clubs looking for bargains during this time of uncertainty. In fact, discount store sales have risen 6 percent from the past year.

.06 In addition to operating losses, retailers are reporting huge losses due to one-time writeoffs for investments in Internet firms and telecom businesses, restructuring charges due to store closings, inventory liquidations, employee layoffs, and bad debt writeoffs. In fact, net income for a number of the nation’s largest companies plunged two-thirds in the second quarter as a result of the massive writeoffs and charges related to the slowing economy.

Consumer Spending Sluggish

.07 Customer turnout continues to remain sluggish as consumer shopping traffic has fallen for the fourteenth week straight through August 2001. Consumer confidence declined for the second month from 116.3 in July 2001 to 114.3 in August 2001. With new jobless claims at a nine-year high, corporate layoffs rising, and a volatile stock market, consumers are cutting spending on discretionary items. Household purchasing power has increased as wages are rising at 4.3 percent, which is still 1 percent faster than inflation. Real consumer spending grew to 1.5 percent annually in the second quarter of 2001, which is the lowest pace in nearly six years. The influx of about \$38 billion in tax rebates and the wave of approximately \$50 billion in mortgage refinancing appear to be helping retail sales in the beginning of the third quarter of 2001.

.08 The September 11, 2001, attack on America injected further agitation and uncertainty into the U.S. economy. The ramifications of that attack and the ensuing war against those responsible for it may deepen the economic slowdown and lead to a recession; however, at the time of the writing of this Alert, the short- and long-term effects of the attack on the economy are uncertain. Nevertheless, only nine days after the attacks, the National Retail Federation lowered its sales growth forecast for the fourth quarter, speculating that the effects on the economy and consumer responses will affect retailer's future sales.

Help Desk—The Financial Accounting Standards Board's (FASB) Emerging Issues Task Force (EITF) reached consensus on issues of accounting for the terrorist attacks of September 11, 2001. This guidance was issued as EITF Issue No. 01-10, *Accounting for the Impact of the Terrorist Attacks*, to provide financial statement preparers and auditors with guidance. The Task Force concluded that, while the events of September 11 were certainly extraordinary, the financial reporting treatment that uses that label would not be an effective way to communicate the financial effects of those events and should not be used in this case. Readers of financial reports will be intensely interested in understanding the whole impact of the events on each company. The EITF concluded that showing part of the effect as an extraordinary item would hinder rather than help effective communication. Practitioners should go to www.fasb.org/eitf/eitf911-101.html for further information about EITF Issue No. 01-10. Also, the AICPA general *Audit Risk Alert*—2001/02 [AAM section 8010] contains an extensive discussion of accounting and auditing issues related to the September 11 attacks.

Retailers' Response to the Weak Economy

.09 In response to the weak economy, retailers are taking steps and pursuing policies designed to help them weather the rough economic seas. They are buying less merchandise for fear of getting stuck with too much again (see the "Inventory" section of this Alert), cutting back on expenses, and creating contingency plans if sales fall below predictions. They are also preparing for what could be the worst Christmas season in a decade by tightly managing inventories and costs. And, for the first time since the 1990 recession, retailers have reduced spending on equipment and software. Since profit projections remain poor, business investments, payroll expenses, and capital spending are being cut by retailers.

.10 **Store Closings.** The cost cutting and restructurings undertaken by retailers have led to an increased number of store closings. In these circumstances, auditors should consider whether management has accounted for these store closings and restructurings appropriately. See the "Store Closings, Restructuring Charges, and Asset Impairments" section of this Alert for a discussion of a number of the accounting and auditing issues that result when a retail entity closes store locations.

.11 **Tough Competition Shaking Retailers Up.** The difficult economic environment has resulted in some very tough competition among retailers. In response, retailers are focusing on new ideas to capitalize on sales opportunities. For example, retailers are putting an increased emphasis on tracking merchandise by analyzing what is not selling, allowing retailers to quickly react through promotions or the shifting of merchandise to other store locations. Also, retailers are reducing inventory levels (see the section of this Alert entitled

“Helping Your Clients Manage Their Inventory During This Economic Downturn”), and retailers are simplifying trend and brand-name messages through clearer displays and more advertising.

.12 Bankruptcies and Going Concern. Many retailers have filed for bankruptcy in the midst of the overall weak retail environment. The sluggish economy and not being able to keep up with the discount chains caused the majority of the bankruptcies. Auditors should be aware of their responsibility to evaluate whether there is substantial doubt about a retailer’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. See the “Going-Concern Issue” and “Troubled Debt Restructurings and Bankruptcy Reorganizations” sections of this Alert.

Electronic Commerce

.13 Despite the economic downturn, established bricks-and-mortar retailers’ online sales leaped to \$5.3 billion in June 2001—a 71 percent increase from June 2000 according to Nielsen/NetRating. The increase in traffic on their e-commerce Web sites is attributable, in many cases, to their well-known name brands and their customer relationships. Their customer base trusts them and knows what to expect from their products. The Internet is a cost-effective channel that allows these traditional retailers to extend their reach.

.14 Many stand-alone Internet retailers are not doing well. Going out and about, roaming aisles, touching and feeling the products seems to appeal to most consumers. At least 232 e-commerce companies have gone out of business since January 2000, according to Webmergers.com.

See the lengthy discussion of the current e-business economic environment in the AICPA Audit Risk Alert, *E-Business Industry Developments—2001/02* [AAM section 8210]. Call the AICPA Order Department at (888) 777-7077 to order. That Alert also contains detailed discussions about the unique accounting and auditing concerns prevalent in an e-business environment.

Regulatory and Legislative Issues

*What recent actions has the IRS taken that possibly may affect your retail clients?
What legislation is on the horizon that may affect your clients?*

Large and Mid-Size Business Division of the IRS

.15 As part of its modernization plan, the Internal Revenue Service (IRS) created the Large and Mid-Size Business (LMSB) Division organized around customer needs. The group includes corporations, Subchapter S corporations, and partnerships with assets over \$5 million. The LMSB will be responsive to the needs of customers in a global environment and apply innovative approaches to customer service and compliance. The LMSB Division addresses key customer needs by improving tax administration in the following four areas:

- More consistent, timely, and direct responses from accountable industry managers through the LMSB Organizational Design
- Reduced examination duration, costs, and burden through enhanced prefiling guidance and issue resolution to resolve issues before forwarding the case to the United States Court of Appeals or the Tax Court
- Improved efficiency in examination cases through case planning and information management
- Reduced examination costs and burden through technology, such as electronic communication and data transfer, to reduce paper retention and exchange

.16 The IRS continues to develop the structure of its LMSB Division. The Division includes a special industry section, headquartered in Chicago, devoted to retailers, food, and pharmaceutical industries with business dealings in beverages, tobacco, garments, small household appliances, hotels, agricultural commodities, and farms. The IRS Web site, www.irs.gov, provides contact information for the leadership of the LMSB Division and currently has a separate page to serve the customers of the Large to Mid-Size Business segment of the Division.

IRS Announcement 2001-82—Required Minimum Distributions

.17 IRS Announcement 2001-82 establishes an alternative model amendment for all qualified stock bonus, pension and profit-sharing plan sponsors under Internal Revenue Code (IRC) Section 401 (a) to use with respect to required minimum distributions made for 2001 but before the date on which the plan began operating under 2001 proposed rules. The announcement was in response to concerns by plan sponsors that intended to use the 2001 proposed regulations for distributions for 2001 but that made required distributions for 2001 under the 1987 proposed regulations. Announcement 2001-82 allows qualified plan sponsors to use the alternative model amendment so that required minimum distributions made for 2001 (but before the date on which the plan began operating under the 2001 proposed rules) are deemed made under the 1987 proposed regulations.

.18 For additional information on the announcement, go to www.irs.gov and see the Internal Revenue Bulletin.

IRS to Tax Stock Option Plans

.19 The IRS has announced its intent to contemplate applying Social Security tax to stock option plans. A stock option purchase plan authorizes employees to purchase shares of their company stock at a discount generally around 15 percent below the market price.

.20 The IRS has determined that it may possibly want to impose the Social Security tax (7.65 percent to the employee, matched by the employer) on the difference between the stock's market price and the discounted purchase price. The IRS maintains that the difference between the purchase price and the market price of the stock represents a type of compensation and therefore should be subject to the Social Security tax.

.21 The IRS plans to impose this tax starting in January 2003 unless the IRS changes its position or Congress votes to block the tax.

Interest-Free Adjustments Under Section 6205

.22 Final regulations under IRC Section 6205 were released by the IRS and the Treasury Department regarding the interest-free adjustment period for underpayment of employment taxes to reflect the changes made by the Taxpayer Relief Act of 1997 (1997 TRA). The final regulations issued and the proposed regulations issued in January 2001 are exactly alike. They affect employers that are the subject of IRS Examinations involving determinations by the IRS that workers are employees for purposes of subtitle C or that the employers are not entitled to relief from employment taxes under section 530 of the Revenue Act of 1978.

Section 6205

.23 IRC Section 6205 allows employers that have paid less than the correct amount of employment taxes to make adjustments without interest, provided the error is reported and the taxes are paid by the last day for filing the return for the quarter in which the error was ascertained. However, no interest-free adjustments are permitted pursuant to IRC Section 6205 after receipt of notice and demand for payment thereof based upon an assessment.

Before the Taxpayer Relief Act of 1997

.24 Section 6205 basically allowed an employer to pay employment taxes for disputed workers on an interest-free basis until the point in time that the IRS issued notice and demand for payment based on an assessment. The 1997 TRA added a new section 7436, which permits an employer to contest certain employment tax issues before the Tax Court. Consequently, the IRS cannot issue notice and demand for payment based on an assessment until after the taxpayer has received a "Notice of Determination Concerning Worker Classification Under Section 7436" and had the opportunity to petition the Tax Court contesting such determination.

Final Regulations

.25 The final regulations provide that, in employment tax examinations involving worker classification or IRC Section 530 issues, as in other types of employment tax examinations, the error is ascertained for purposes of IRC Section 6205 when the employer has exhausted all internal appeals within the IRS. Accordingly, the regulations prohibit interest-free adjustments after a taxpayer receives a notice of determination. However, if, before receiving such notice, a taxpayer makes a remittance, the IRS will consider such remittance to be a payment of tax and assess it on an interest-free basis (and will issue a notice of determination only if some portion of the proposed liability remains).

Effective Date

.26 The regulations are applicable with respect to notices of determination issued on or after March 19, 2001. For interest computation purposes, the final regulations will apply to claims for refund of interest pending on January 17, 2001.

Bankruptcy Legislation in Washington

.27 The U.S. House of Representatives and the U.S. Senate have appointed conferees to draft a final version of the Bankruptcy Reform Act of 2001 to be sent to the President for his signature.

.28 The National Retail Federation, long awaiting this action, claims that the absence of bankruptcy reform legislation costs retailers millions of dollars on a daily basis. Retailers are directly affected by this legislation since consumers more often than not finance highly priced items like televisions and furniture with installment debt. When consumers file for bankruptcy, retailers may be able to recover only some of the debt. This legislation is meant to protect the safety net of bankruptcy for those who really need it. Filing for bankruptcy, if this legislation is passed, will be more difficult if you have the means to repay your debt. The legislation will affect about 11 percent of those who file for bankruptcy with an estimated savings of \$4 billion in debt annually that would currently be discharged—almost \$11 million daily!

Debt Default and Delinquencies Rising—Bankruptcy Reform Needed Now

.29 If the legislation is enacted, it comes at an opportune time for retailers since consumer debt is at an all-time high despite the slowing economy. Debt levels have risen due to substantial credit card account growth in 2000 and easier credit terms for consumers. According to the Federal Reserve Data, consumer debt in America now exceeds \$1.5 trillion. Revolving debt jumped about 11 percent last year. Also, by the end of 2000, household debt service payments as a percentage of disposable personal income rose to more than 14 percent, the highest it has been since 1986.

.30 Moody's Investor Services stated that the late payment and bad loan writeoff rate rose by over 13 percent from the prior year. Based on those statistics, consumer credit quality has not been this dismal since the negative credit cycle in 1995 to 1997. Moreover, Standard & Poor's found that credit card issuers wrote off uncollectible balances at an annual rate of 6.7 percent—also the highest rate loss since February 1997.

.31 The disappointing economic outlook raises the specter of growing defaults and bankruptcies. Many retailers are already seeing increases in their credit card chargeoffs.

Taxation of Internet Sales: The Debate Continues

Will there be taxation of Internet sales?

.32 For the past few years, we have been following the continuing debate over the taxation of Internet sales. State and local governments are concerned about losing sales and use tax revenue because of untaxed Internet sales. A recent estimate of the amount of sales tax revenue that will be lost in 2001 because of the nontaxation of Internet sales puts the amount at \$2 billion.

.33 During the saga of the taxation of Internet sales last year, the Advisory Commission on Electronic Commerce (ACEC) had just submitted its report to Congress. That report recommended that, among other actions, Congress (1) extend the existing ban (which is slated to expire in October 2001) on new taxes on Internet access and on multiple or discriminatory taxes on e-commerce, and (2) take steps to simplify state and local sales and use taxes. (Internet businesses claim that disparities in sales tax systems among the various jurisdictions are too burdensome to administer.) Despite the introduction of numerous bills, Congress was unable to pass Internet taxation legislation this year. However, the attempts continue.

Recent Developments

.34 More recently, on July 18, 2001, the Internet Tax Moratorium and Equity Act (H.R. 1410) was introduced in Congress. The bill ostensibly seeks to simplify state and local governments' complex sales tax structures to establish a uniform streamlined sales tax system. In turn, bricks-and-mortar retailers and Internet retailers will treat all retail sales of tangible property in the same manner. The current moratorium, the Internet Tax Freedom Act of 1998 (ITFA), on access taxes and on new discriminatory taxes on the Internet, would be extended until December 31, 2005, however, Congress failed to pass new legislation and the moratorium on Internet taxes expired on October 21, 2001. Analysts and lawmakers say it is unlikely that state and local governments will rush to impose e-commerce sales taxes, but given enough time and an increasing need to raise revenues, that could change. There is concern that tax officials around the country could begin interpreting a variety of their current tax laws as applying to the Internet. Observers say such a move would drag down a crucial engine of the U.S. economy, adding to the nation's economic woes.

State Sales Tax Simplification

.35 Simplifying the tax code should help retailers. First, tax policy should not provide one retailer with an advantage over another. Since profit margins are often narrow in the retail industry, out-of-state retailers who do not have to charge sales tax have a significant pricing advantage over those that do. Second, it would make filing tax returns easier. Some multistate companies file as many as ten thousand different forms with taxing jurisdictions across the country. The states are attempting to address the issue of sales tax simplification. The District of Columbia, forty-five states, and thousands of local governments impose sales taxes. To address complaints about disparities among the jurisdictions, the National Governors Association created the streamlined sales tax project (SSTP). The SSTP, comprising tax administrators from thirty states, developed model legislation to unify and simplify sales and use tax administration among the states that adopt the legislation. The SSTP hopes that, by unifying and simplifying sales tax systems, Internet businesses will voluntarily collect sales taxes. The model legislation, entitled the Uniform Sales and Use Tax Administration Act (the Act), would authorize a state taxing authority to enter into an interstate contract, the Streamlined Sales and Use Tax Agreement (the Agreement). The Act and the related Agreement would, among other matters, establish more uniform administrative standards, and develop and adopt uniform definitions of sales and use tax terms.

.36 Recently, the Act ran into a snag when a task force of the National Conference of State Legislatures (NCSL) took significant exception to some of its measures. The NCSL drafted and distributed its own version

of model legislation to simplify sales tax. State legislatures are now considering whether to adopt legislation and, if so, which version.

Help Desk—The Act is available on SSTP's Web site at www.streamlinedsalestax.org. The NCSL's version of the model legislation is available on the NCSL Web site at www.ncsl.org/programs/fiscal/tctelcom.htm. The NCSL site also includes a document that lists the amendments that the NCSL made to the SSTP Act.

Nevada Passes a Sales Tax Law

.37 Nevada has enacted a law, A.B. 455, that requires out-of-state vendors that sell tangible personal property over the Internet or by other electronic means to Nevada customers to collect use tax on those sales. A.B. 455 has revised the definition of "a retailer maintaining a place of business" in the state to include the following.

A retailer soliciting orders for tangible personal property . . . through a Web site on the Internet or other means of electronic communication to provide solicitations to persons in this state.

Also effective June 13, 2001, retailers soliciting orders from persons located in Nevada via a Web site are treated as "maintaining a place of business" (defined to include not just maintaining an office, but also various other activities, including soliciting orders via television, Web sites, and a toll-free telephone number) in the state and are required to collect sales and use taxes.

New York State Ruling

.38 The New York Department of Taxation and Finance also ruled earlier this year that the sale of music delivered electronically over the Internet is neither a taxable sale of tangible personal property nor the provision of a taxable information or entertainment service.

.39 New York treats digitally downloaded music and digitally downloaded software differently. Digitally downloaded software is treated as a sale of tangible personal property, which is subject to sales tax in New York. Currently, some states treat the sales of digitally delivered software as sales of tangible personal property, others consider these sales of a taxable service, while still others deem them sales of intangible property that are exempt from sales tax.

Audit Issues and Developments

Collectibility of Receivables (Allowance for Doubtful Accounts)

What are some of the audit issues that may arise when considering the collectibility of receivables?

.40 With current high levels of consumer bankruptcies, the collectibility of receivables may be a more significant issue this year. Bankruptcies are discussed further in the section entitled "Bankruptcy Legislation in Washington" in the "Regulatory and Legislative Issues" section of the Audit Risk Alert.

.41 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.) When auditing estimates, 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. Practitioners should also refer to the section, "Evaluating Accounting Estimates Relevant to Revenue Recognition," of this Alert for additional guidance. The guidelines set forth by SAS No. 57 include the following:

- Identify the circumstances that require accounting estimates.
- Consider internal control relating to developing accounting estimates.
- Evaluate the reasonableness of management's estimate.

.42 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:

- a. Review and test the process used by management to develop the estimate.
- b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- c. Review subsequent events or transactions occurring prior to completion of fieldwork, including chargebacks from credit card companies.

.43 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 in obtaining an understanding of how the allowance was developed and determining whether it is reasonable. Testing the reasonability of the company's estimate of the collectibility of receivables may also be performed by using the following procedures:

- a. Obtain publicly available information on major customers to determine their ability to honor outstanding obligations to the company.
- b. Investigate unusual credit limits or nonstandard payment terms granted to customers.
- c. Test subsequent collections of receivables.

.44 Another very useful tool in evaluating the allowance for doubtful accounts is the application of analytical procedures. According to SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329.02), analytical procedures are an important part of the audit process and consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. 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 procedures helpful to the audit process. The following are examples of the ratios that auditors might use to evaluate collectibility of accounts receivable:

- *Accounts receivable turnover* indicates how well the company collects its receivables and is computed as net credit sales divided by average net accounts receivable.
- *Bad debts to net credit sales* indicates whether writeoffs are adequate. It is computed as bad debt expense divided by net credit sales.
- *Doubtful accounts allowance to accounts receivable* indicates whether the allowance account is adequate. It is computed as an allowance for doubtful accounts divided by accounts receivable.

.45 The auditor may also review revenue and receivables transactions and fluctuations after the balance-sheet date for items such as sales and writeoffs. This may provide additional information about the collectibility of the accounts receivable and the reasonableness of the allowance account on the balance-sheet date.

.46 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.

.47 Also, auditors of retail entities that have transferred receivables should evaluate whether management has properly implemented FASB Statement of Financial Accounting Standards No. 125,¹ *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.

Going-Concern Issue

Why is going concern an important issue for the retail industry?

What is the auditor's responsibility in addressing it?

.48 Historically, the retail industry's sensitivity to negative changes in economic conditions, such as reductions in personal income, layoffs, higher unemployment levels, and decreases in consumer confidence, have resulted in high rates of business failures. Accordingly, auditors should be alert to conditions and events which, when considered in the aggregate, indicate that there could be substantial doubt about the retail entity's ability to continue as a going concern.

.49 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 product line, or (4) external matters such as legal proceedings or loss of a principal supplier. Another condition which may raise doubt about an entity's ability to continue as a going concern could be excessive and unusual reliance on external financing, rather than money generated from the companies' own operations as evidenced by many dot.com retailers that shut down or filed for bankruptcy this past year, including Pet.com, Quepasa.com, Mothernature.com, and ValueAmerica.com, just to name a few. In such circumstances, auditors will have to consider whether, based on such conditions and events, there is substantial doubt about the retailer's ability to continue as a going concern.

Auditor's Responsibilities Related to a Going-Concern Issue

.50 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 in conducting an audit of financial statements in accordance with generally accepted auditing standards (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.

.51 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. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

¹ This Statement was replaced by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, which is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after March 31, 2001. See the "Accounting Pronouncements and Guidance Update" section of this Alert for more information on FASB Statement No. 140.

.52 If there is substantial doubt about the entity's ability to continue as a going concern, the auditor should consider whether it is likely that existing conditions and events can be mitigated by management plans and whether those plans can be effectively implemented. If the auditor obtains sufficient competent evidential matter to alleviate doubts about going-concern issues, then consideration should be given to the possible effects on the financial statements and the adequacy of the related disclosures. If, however, after considering identified conditions and events, along with management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern remains, the audit report should include an explanatory paragraph to reflect that conclusion. In these circumstances, auditors should refer to the specific guidance set forth under SAS No. 59.

Retailers in Bankruptcy Reorganization

.53 For those retail entities that are under bankruptcy reorganization pursuant to chapter 11 of the Bankruptcy Code or emerging from it, the auditor should consider whether the company is following the accounting guidance of SOP 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*. Retail entities that filed for bankruptcy may have impairments that need to be recorded prior to fresh-start accounting under SOP 90-7.

Inventory

*What are the risks in the area of inventory?
What effect will they have on audits for retail entities?*

Obsolete or Excess Inventory

.54 Numerous retail companies were far too optimistic in their economic forecasts, resulting in overstocking, overexpansion, and warehouses bulging with inventory. Some retailers have sought out deep discounters, barter companies, and liquidators to help relieve excessive levels of inventory.

.55 The primary literature on inventory accounting is Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*. Chapter 4 of ARB No. 43 states:

[I]n keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories shall be stated at cost. . . A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. If the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes, a loss [shall] be reflected as a charge against the revenues of the period in which it occurs. The measurement of such losses shall be accomplished by applying the rule of pricing inventories at cost or market, whichever is lower.

.56 The appendix to SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.26), lists the following substantive tests that the auditor might want to consider in identifying slow-moving, excess, defective, and obsolete items included in inventories:

- a. Examine an analysis of inventory turnover.
- b. Review industry experience and trends.
- c. Analytically compare the relationship of inventory balances to anticipated sales volume. (The "Analytical Procedures" section below describes some of the ratios commonly used in a retail environment to evaluate the reasonableness of inventory valuation and to help identify the existence of obsolete inventory.)

- d. Tour the facility.
- e. Inquire of sales and other relevant personnel concerning possible excess or obsolete items.

.57 When significant excess or obsolete inventories exist, it may be appropriate to include the matter in the management representation letter. SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333.17), provides the following illustrative example of such a representation: "Provision has been made to reduce excess or obsolete inventories to their estimated net realizable value."

Analytical Procedures

.58 To evaluate the reasonableness of inventory valuation and to help identify the existence of obsolete inventory, the auditor may wish to consider using analytical procedures as described below. Auditors should be aware of the need to have these procedures performed by staff with sufficient industry expertise to properly evaluate the results. In performing analytical procedures, auditors compare 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, and Standard & Poor's)

.59 The following gives a brief description of some of the ratios commonly used in a retail environment for inventory valuation:

- The *gross profit ratio* indicates whether profit goals will be met and whether there are unusual variances in the cost of sales and inventory, and is computed as gross margin divided by net sales.
- The *inventory turnover ratio* indicates how well merchandise inventory is managed and whether sales problems exist. It is computed as the cost of goods sold divided by average inventory.
- 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.
- *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.
- *Inventory shrinkage as a percentage of sales* indicates the percentage of inventory loss resulting from theft and/or bookkeeping errors. Many retailers look at the trend of inventory shrinkage as a percentage of sales from period to period and on a location-by-location basis. This is calculated by taking the book inventory minus the physical inventory divided by net sales.
- *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.
- *Inventory by location* provides a check on whether the amount of inventory at each location is reasonable (or even possible). Various calculations are possible, such as using total by location, square foot by location, dollar values, or quantities of inventory.

Help Desk—For additional guidance the auditor should refer to the new AICPA *Analytical Procedures Guide* (Product No. 012551). Call the AICPA at (888) 777-7077 to order.

Helping Your Client Manage Their Inventory During This Economic Downturn

.60 Good inventory management has become an important determinant in the success of a business in the retail industry today. As the U.S. economy began to slow and demand began to weaken, retailers found themselves with surplus inventories. The stores that are thriving, such as Wal-Mart and H & M clothing retailer, are less likely to maintain stale inventory. Inventories have climbed to \$4 billion, up from just \$250 million a year ago according to liquidation experts. Retailers are becoming averse to retaining mounds of inventory attributable to the lack of spending by consumers during this weak economy. Even the biggest retail giants, Wal-Mart and Target, are being conservative in regard to the intake of inventory. Inventory levels fell for the fifth straight month in August 2001 according to the U.S. government. Retailers are being extremely cautious about future demand. In prior years, retailers have been in inventory building modes, and these days they must make the transition to the maintenance mode. Factory inventory levels are at their lowest in almost twenty years according to the National Association of Purchasing Management of Chicago. The U.S. Commerce Department reported that during the second quarter, businesses curtailed inventories at a rate of \$38.4 billion per year and the gross domestic product grew at 0.2 percent annual rate.

.61 Practitioners can assist their retail clients in establishing and maintaining effective controls over inventory during this economic downturn in some of the following areas:

- *Physical Inventory.* Practitioners can assist their clients in developing written instructions for taking inventory while highlighting the importance of good documentation during the physical inventory. AU Section 331, *Inventories* (AICPA, *Professional Standards*, vol. 1, AU sec. 331), discusses the requirements to observe inventories, periodic comparisons with physical counts, and inventory controls (including statistical sampling) on procedures used by the auditor.
- *Perpetual Inventory.* Practitioners can assist clients in optimizing the full potential of their perpetual inventory systems by helping their clients implement an inventory in transit procedure to ensure the proper recording of inventory shipped FOB shipping point along with the related accounts payable. You may suggest using a separate control account to record the inventory in transit, which would be reversed when the goods are received and entered into the perpetual inventory system. Also, by assisting the client in ensuring that all inventory that has been purchased has been included in inventory and accounts payable, the practitioner can help minimize inventory cutoff errors.
- *Markdowns.* Practitioners can help clients develop a procedure to monitor markdowns to confirm that only authorized markdowns are taken in order to control inventory levels and fulfill its planned profit expectations. The appropriate level of management should supervise markdowns closely, regardless of whether the cost or retail method is used in order to achieve those goals.
- *Shrinkage.* Practitioners can assist clients in implementing effective paperwork control by instituting internal controls to help prevent errors and to find them as they occur. The practitioner can also assist in minimizing the risk of loss from theft, both internal and external, by the means of setting up operating policies, practices, and procedures. For example, this can be done in areas such as store closings, transfers, store openings, and merchandise receiving operations (not all inclusive).
- *Employee Purchases.* Practitioners can assist clients in establishing procedures that keep track of employee purchases on an individual basis to monitor possible abuse so it may be detected and resolved in a more timely manner.
- *Open-to-Buy.* Practitioners can assist in instituting and supporting an open-to-buy (OTB) system to help ensure that inventory levels will be adequate to satisfy budgeted sales. It will also help retailers reduce the amount of resources they tie up in slow-moving inventories, which during the current economic environment, can be devastating to retailers.

Inventory Fraud

What auditors should know to help uncover phony figures.

.62 As the economy downshifts and management is under pressure, companies may be more prone to inventory fraud. Practitioners who are familiar with common methods for fraudulent inventory manipulations will be in a much better position to identify them.

.63 There are many ways a dishonest client can attempt to manipulate inventory. Those clients usually use a combination of several methods to commit inventory fraud: fictitious inventory, the manipulation of inventory counts, the nonrecording of purchases, and fraudulent inventory capitalization. All these elaborate schemes have the same goal of illegally boosting inventory values.

.64 Auditors are not responsible for detecting fraud *per se*, however, auditors do have a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements, whether caused by error or fraud. The issuance of SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), did not change the auditor's responsibility with respect to fraud, but was designed to help auditors to fulfill their responsibility to detect material misstatements caused by fraud.

.65 Among other things, the Standard:

- Describes the characteristics of fraud. The more the auditor knows about the nature of fraud, the better he or she will be equipped to identify risk factors, assess the risk of material misstatement attributable to fraud, and develop an appropriate audit response.
- Requires the auditor to make an assessment as to the risk of material misstatement attributable to fraud, from the perspective of the broad categories listed in the SAS. The assessment is separate from but may be performed in conjunction with other risk assessments made during the audit. The SAS also requires the auditor to reevaluate the assessment if other conditions are identified during the fieldwork.
- Provides examples of fraud risk factors that, when present, might indicate the presence of fraud.
- Requires the auditor to document evidence of the performance of the fraud risk assessment, including risk factors identified as being present and the auditor's response to those risk factors.
- Requires the auditor to communicate to management at the appropriate level and, in certain circumstances, directly with the audit committee.

.66 Auditors must maintain an appropriate attitude of professional skepticism. This means assuming neither that the management is dishonest nor that it is unquestionably honest; obtaining corroborating evidence for management representations; considering whether misstatements may be the result of fraud; and appropriately designing and performing auditing procedures to address fraud risk factors. The application of professional skepticism in response to the auditor's assessment of the risk of material misstatement attributable to fraud might include (1) increased sensitivity in the selection of the nature and extent of documentation to be examined in support of material transactions, and (2) increased recognition of the need to corroborate management explanations or representations concerning material matters, such as, further analytical procedures, the examination of documentation, or discussions with others within or outside the entity.

Fraudulent Asset Valuations

.67 Companies use five different techniques to illegally boost assets and profits:

- a. Fictitious revenue
- b. Fraudulent timing differences

- c. Concealed liabilities and expenses
- d. Fraudulent disclosures
- e. Fraudulent asset valuations

The misstatement of asset valuations is the most common form of inventory fraud. Inventory overstatement makes up the majority of asset valuation frauds and is the focus of this section.

.68 The valuation of inventory involves two separate elements: quantity and price. Goods are constantly being bought and sold, and transferred among locations. Figuring the unit cost of inventory can be problematic, too; FIFO, LIFO, average cost, and other valuation methods can routinely make a material difference in what the final inventory is worth. As a result, the complex inventory account is an attractive target for fraud.

.69 The obvious way to increase inventory asset value is to create various records for items that do not exist, including unsupported journal entries, inflated inventory count sheets, bogus shipping and receiving reports, and fake purchase orders. Since it can be difficult for the auditor to spot such phony documents, he or she may use other means to substantiate the existence and value of inventory.

Auditing Procedures

.70 Since the auditor relies heavily on observing the client's inventory, the auditor's taking and documenting of the test counts is important. During the observation of the physical inventory, the auditor should validate the inventory quantity by test counting. Even when this is done, inventory fraud can go undetected. The following are examples:

- Management representatives follow the auditor and record the test counts. Thereafter, the client can add phony inventory to the items not tested, in turn falsely increasing the total inventory values.
- Auditors announce when and where they will conduct their test counts. For companies with multiple inventory locations, this advance warning may permit management to conceal shortages at locations which auditors will not visit.
- Sometimes auditors do not take the extra step of examining packaged boxes. To inflate inventory, management may stack empty boxes or boxes may contain items other than inventory in the warehouse.

.71 Practitioners can use analytical procedures to help detect ghost goods. *Ghost goods* are phantom inventories, which may throw off a company's books. For example, if the auditor compares the books with previous periods, the cost of sales will be too low; inventory and profits will be too high. There will be other signs, too. When analyzing a company's financial statement over time, the auditor can look for the following trends:

- Inventory increasing faster than sales
- Decreasing inventory turnover
- Shipping costs decreasing as a percentage of inventory
- Inventory rising faster than total assets move up
- Falling cost of sales as a percentage of sales
- Cost of goods sold on the books not agreeing with tax returns

An alert auditor may be able to detect inventory fraud schemes by any one of the above analytical methods. The auditor can also examine the cash disbursements subsequent to the end of the period. If the auditor finds

payment made directly to vendors that were not recorded in the purchase journal, he or she should investigate further.

Assessing the Risk of Inventory Fraud

.72 Practitioners should refer to SAS No. 82 for guidance. In evaluating the risks of inventory overstatements, the auditor may answer the following questions. Many *yes* answers to the following may indicate a greater risk of inventory fraud:

- Is inventory a significant balance-sheet item?
- Is the company attempting to obtain financing secured by inventory?
- Has the percentage of inventory to total assets increased over time?
- Has the ratio of cost of sales to total sales decreased over time?
- Have shipping costs fallen compared with total inventory?
- Has inventory turnover slowed over time?
- Have there been significant adjusting entries that have increased the inventory balance?
- After the close of an accounting period, have material reversing entries been made to the inventory account?

.73 Auditors may need to adjust the scope of their audits if control risk, associated with inventory controls, is assessed as high. The auditor should document the understanding of the entity's internal control as required by SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended. If the understanding reveals weakness in inventory controls, there may be an increased risk of material misstatements and fraud in the financial statements. Also, reportable conditions, as defined in SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended, may exist.

Evaluating Accounting Estimates Relevant to Revenue Recognition

How practitioners can evaluate the reasonableness of accounting estimates.

.74 In light of the current economic slump, management is under great pressure to show good results. Since revenue is an easy target to boost up profits, it may be inflated. So, auditors may need to pay particular attention to revenue recognition issues.

.75 The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. The evaluation of estimates is always an area of auditing concern because the measurement of estimates is inherently uncertain and depends on the outcome of future events. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342.10), sets forth guidance for auditing estimates. Refer to the "Collectibility of Receivables (Allowance for Doubtful Accounts)" section of this Alert for a description of those guidelines.

.76 Estimates relevant to the retail industry that are significant to management's assertion about revenue include sales returns and the allowance for doubtful accounts. An adequate allowance for doubtful accounts assumes increasing importance in the face of today's slowing economy, abundance of store closings, consumer loan payment delinquencies, and bankruptcies. Auditors often use historical data to evaluate the reasonableness of such estimates as reserves for sales returns. Historical data may indicate client practices to take back inventory even when no contractual right of return exists. Analysis of the aging of the accounts receivable that reflects a "building up" of receivables may indicate contingent sales or concessions to customers regarding the return of goods. Auditors also should consider reviewing sales to major customers,

particularly to distributors, to detect excess purchases (channel stuffing) that may be at greater risk of return in the subsequent period. A company's ability to make reasonable estimates of sales returns may be impaired if the company does not have sufficient visibility into what is going on in the sales channel. Reliance on solely historical averages may be insufficient, especially if the environment is somewhat volatile.

.77 The ability to make reasonable estimates of future returns is one of the conditions that must be met for recognition of revenue at the time of sale, in accordance with FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*. FASB Statement No. 48 establishes accounting and reporting standards for sales of a product when the buyer has the right to return the product. Paragraph 6 provides that, in such circumstances, revenues from the sales transactions should be recognized at the time of sale only if *all* of the following conditions are met:

- a. The seller's price to the buyer is substantially fixed or determinable at the date of sale.
- b. The buyer has paid the seller, or the buyer is obligated to pay the seller and the obligation is not contingent on the resale of the product.
- c. The buyer's obligation to the seller would not be changed in the event of theft or physical destruction or damage of the product.
- d. The buyer acquiring the product for resale has economic substance apart from that provided by the seller.
- e. The seller does not have significant obligations for future performance to directly bring about the resale of the product by the buyer.
- f. The amount of future returns² can be reasonably estimated (paragraph 8).

If the preceding conditions are not met, sales recognition should be postponed until the right of return substantially expires or until such time as the conditions are met.

.78 If revenue is recognized at the time of sale because the above conditions are met, FASB Statement No. 48 requires that the costs or losses that may be expected in connection with returns must be accrued in accordance with FASB Statement No. 5, *Accounting for Contingencies*. The sales revenue and cost of sales reported in the income statement should be reduced to reflect estimated returns.

.79 Paragraph 8 of FASB Statement No. 48 describes a number of factors that may impair (but not necessarily preclude) the ability to make a reasonable estimate of the amount of future returns. Among those factors are the susceptibility of the product to significant external factors (for example, obsolescence or changes in demand); the absence of or lack of relevance of historical experience to the circumstances (for example, if a product, market, or customer is new); the length of the return period; and the absence of a large volume of relatively homogeneous transactions.

.80 In addition to analyzing historical data and the accounts receivable aging reports, auditors' should consider testing the company's estimate of the collectibility of receivables. Practitioners should refer to the "Collectibility of Receivables (Allowance for Doubtful Accounts)" section of this Alert for the procedures to be followed.

Help Desk—For additional guidance, the auditor should refer to the AICPA Practice Aid *Auditing Estimates and Other Soft Accounting Information* (Product No. 010010kk) and the AICPA Audit Guide *Auditing Revenue in Certain Industries* (Product No. 012510). Call the AICPA at (888) 777-7077 to order.

² 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 for purposes of this Statement.

Accounting Issues and Developments

Store Closings, Restructuring Charges, and Asset Impairments

What accounting issues arise with respect to store closings?

.81 In this weak economic period and harsh retail climate, retailers are continually evaluating the performance of individual stores and considering whether it might be necessary to close those stores. In the past year, many retailers have had to close stores as a result of the adverse economic conditions. Retailers such as JC Penney, Sears Roebuck & Co., Saks Fifth Avenue, Krause's Furniture Inc., Albertson's Inc., Montgomery Ward, Bradlees Inc., Office Max, Office Depot, Lechters, Ames Department Stores, Dillards, and Sterns, just to name a few, have posted sizable charges related to shutdowns. As many retailers are closing stores, discount retailers such as Wal-Mart, Target, Costco, Kohls, and Family Dollar Stores are adding new stores in response to the slowing economy and bargain-oriented customers.

.82 Also in the wake of this bleak economic picture and in response to intense competitive pressures, retailers such as Lechters Inc., Tupperware Corp., Albertsons Inc., and iGo Corp., have had huge nonrecurring charges as a part of their restructuring plans. Restructure costs may include store closings, job reductions, sale of business segments, reductions in the number of operating divisions, disposal of assets, asset impairment, and eliminating or combining certain functions or departments in an attempt to reduce the cost structure and spur future profitability and return of capital. Auditors need to address a number of issues concerning store closings.

Need to Accrue for the Costs of the Exit Plan

.83 The auditor needs to determine whether management has properly addressed the requirements of EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*, and, for Securities and Exchange Commission (SEC) clients, Staff Accounting Bulletin (SAB) No. 100, *Restructuring and Impairment Charges*. Auditors should 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 that are subsequently charged against such reserves, or the reversals of excess amounts of such liability reserves, should be clearly disclosed. For further guidance on disclosures, auditors should refer to EITF Issue No. 94-3 and SAB No. 100, as they both address disclosure requirements that must be followed by the organizations beginning with the period in which the exit plan is committed and ending with the point at which the exit plan is completed.

.84 When evaluating the criteria necessary to accrue for the costs of an exit plan, auditors should be aware of restrictive standards set in EITF Issue No. 94-3 for plan specificity. It states that the exit plan should specifically identify all significant actions to be taken to complete the exit plan and the period of time to complete the plan should indicate that significant changes to the exit plan are not likely. In determining the specificity of a retailer's exit plan, the SEC staff suggests that auditors may wish to consider whether the exit plan is sufficiently detailed so that the retailer can and will use it to (1) evaluate the performance of those responsible for executing the plan and (2) identify and react to plan versus actual performance. According to SAB No. 100, auditors should consider whether the exit plan is at least comparable to other operating and capital budgets the retailer prepares in terms of the level of detail and reliability of estimates. Furthermore, auditors should consider whether it is more likely than not that either the exit plan itself, or significant actions identified within the exit plan, will be materially revised in response to events or circumstances that are likely to occur. If so, the exit plan may not be sufficiently detailed and thus not meet the criteria for accrual of related costs under EITF Issue No. 94-3.

.85 Finally, auditors should be aware that EITF Issue No. 94-3 permits accruals to be made only for those costs associated with specifically identified significant actions that can be reasonably estimated at the exit

plan's commitment date. SAB No. 100 discusses in further detail factors that need to be considered in evaluating the plan's specificity. Those factors include the reliability of estimated costs, the level of identification and the aggregation of costs, and the timetable within which the exit plan is expected to be completed.

.86 According to SAB No. 100, after the exit plan is evaluated and the amount of accrual is determined, it is not final and might have to be adjusted because of a change in circumstances. The SAB states that at each balance-sheet date, exit costs accruals should be evaluated to ensure that any accrued amount no longer needed for its originally intended purposes is reversed in a timely manner. Reversal of the liability should be recorded through the same income statement line item that was used when the liability was initially recorded. Costs actually incurred in connection with an exit plan should be charged to the exit accrual only to the extent those costs were specifically included in the original estimation of the accrual. Costs incurred in connection with an exit plan but not specifically contemplated in the original estimate of the liability for exit costs should be charged to operating expense in the period incurred, or the period that the exit costs qualify for accrual under EITF Issue No. 94-3, with appropriate explanation presented in the Management's Discussion and Analysis.

Employee Termination Benefits

.87 EITF No. 94-3 requires a liability to be recorded in the period that management approves a store closing for benefits paid to involuntarily terminated employees if the conditions are met to accrue the costs to exit an activity as well as meeting the conditions to record a liability for employee termination benefits according to EITF No. 94-3. Practitioners should refer to the EITF for the specific conditions.

.88 EITF No. 94-3 also provides guidance for voluntary termination arrangements and when employees are required to work until they receive the benefits offered.

.89 Practitioners should refer to EITF No. 94-3 for required disclosures related to employee termination costs.

Unusual and Infrequent Items

.90 Unusual and infrequent (but not both) transactions or events are to be presented in the statement of income as separate elements of income from continuing operations as required by Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*. The presentation should not imply that the amounts are extraordinary items since they do not meet the criteria of being both infrequent and unusual. Practitioners may present store closings on the face of the statement of income as a component of continuing operations such as provision for store closing.

.91 Disclosures stating the effect and nature of the transaction or event can be made in the notes to the financial statements using captions such as unusual items or nonrecurring items, as well as on the face of the statement of income as stated above.

Inventory Markdowns

.92 The auditor should determine 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, as provided in SAB No. 67, *Income Statement Presentation of Restructuring Charges*, has been followed regarding the classification as a component of cost of goods sold for markdowns associated with a restructuring.

Lease Modifications

.93 The auditor needs to find out whether the client, as a result of the decision to close a store, 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*.

Other Concerns

.94 Additional matters that may need to be addressed in light of store closings include the collectibility of accounts receivable and the accounting for handling and shipping costs when transferring merchandise to other stores.

Need to Accrue for Restructuring Charges

.95 You should also consider whether management has appropriately accounted for restructuring costs. EITF Issue No. 94-3 also provides guidance on whether certain costs (such as employee severance and termination costs) should be accrued and classified as part of restructuring charges, or whether such costs would be more appropriately considered a recurring operational cost of the organization. The EITF provides guidance about the appropriate timing of recognition of restructuring charges and the related disclosures as well.

Management's Plan

.96 To justify restructuring charges, an approved management plan as of the date of the financial statements should exist. Management's plan should be comprehensive, explicit, and adequately documented to provide objective evidence of management's intent.

.97 Loss recognition that is based on management's intent must be supported by objective evidence of intent. To demonstrate management's intent, you may consider whether the plan is sufficiently developed to forecast its consequences and management's commitment to ultimately implement the plan as contemplated. A documented and appropriately approved management plan that is comprehensive and explicit is necessary to accrue a liability.

.98 Practitioners should also evaluate whether the restructuring charges are in violation of loan covenant agreements.

Making Disclosures

.99 When liabilities are accrued in accordance with the guidance in EITF Issue No. 94-3, 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.

.100 Some of the disclosures are required until the plan of termination is completed or until all actions under a plan to exit an activity 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.

Making Sure Accruals Are Not "Cushions"

.101 Sometimes, frequent reductions to restructuring liabilities may suggest that management has provided a cushion by overstating the accrual. When reviewing management's accruals, you should be aware of the kinds of charges that are allowed to be accrued for, pursuant to EITF Issue No. 94-3 and other relevant accounting literature, as appropriate. For example, FASB Statement No. 5 refers to "reserves for general contingencies." No accrual shall be made or disclosure required since general business risks do not meet the conditions for an accrual as stated in paragraph 8 of FASB Statement No. 5.

Impairment of Assets

.102 Management is responsible for evaluating whether a store closing constitutes an event or a change in circumstances indicating that the carrying amount of an asset in question may not be recoverable.

- *Old Guidance.* Auditors should evaluate management's consideration of FASB Statement No. 121, *Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, 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 No. 30. Assets covered by APB Opinion No. 30 will continue to be reported at the lower of the carrying amount or the net realizable value. The SEC's SAB No. 100, among other things, discusses the impairment of fixed assets and goodwill.
- *New Guidance.* The FASB has issued FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in August of 2001. The Statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. The Statement supersedes FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, and the accounting and reporting provisions of APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, for the disposal of a segment of a business (as previously defined in that Opinion). FASB Statement No. 144 was issued because FASB Statement No. 121 did not address the accounting for a segment of a business accounted for as a discontinued operation under APB Opinion No. 30, two accounting models existed for long-lived assets to be disposed of. The Board decided to establish a single accounting model, based on the framework established in FASB Statement No. 121, for long-lived assets to be disposed of by sale. The Board also decided to resolve significant implementation issues related to FASB Statement No. 121. The provisions of FASB Statement No. 144 are effective for financial statements issued for the fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early application encouraged.
- Also practitioners should refer to FASB Statement No. 142, *Goodwill and Other Intangible Assets*, issued in June 2001, for guidance on the recognition and measurement of impairment losses for goodwill and intangible assets. The Statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, *Intangible Assets*. It addresses how intangible assets that are acquired individually or with a group of other assets (but not those acquired in a business combination) should be accounted for in financial statements upon their acquisition. The Statement also addresses how goodwill and other intangible assets should be accounted for after they have been initially recognized in the financial statements. FASB Statement No. 142 is effective starting with fiscal years beginning after December 15, 2001. Early application is permitted for entities with fiscal years beginning after March 15, 2001, provided that the first interim financial statements have not previously been issued. The Statement is required to be applied at the beginning of an entity's fiscal year and to be applied to all goodwill and other intangible assets recognized in its financial statements at that date. Impairment losses for goodwill and indefinite-lived intangible assets that arise due to the initial application of this Statement (resulting from a transitional impairment test) are to be reported as resulting from a change in accounting principle.

Multiple Leased Locations

How does the existence of multiple leased locations affect the auditor of retail entities?

.103 Retailers often operate from multiple locations, including stores and warehouses, and these locations can change or can be eliminated 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.

.104 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 whether 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).

.105 Some of the issues the auditor may encounter when evaluating the lease under these standards are:

- a. The lease may only apply to a portion of a building.
- b. Equipment may be included in the rental.
- c. The fair market value of the leased property may not be easily determinable.
- d. The economic life of the leased property may not be easily determinable.

.106 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, *Accounting for Leases*, 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.

.107 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 EITF relating to leasing transactions. EITF Issue No. 98-9, *Accounting for Contingent Rent in Interim Financial Periods* 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 or lessee's fiscal year.

.108 The auditor should also review leases for upcoming lease expiration dates, penalties for early terminations (especially with the large amount of recent store closings), requirements that the client make changes to the premises, and other terms.

.109 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 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.

.110 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.

.111 The auditor needs to be aware of various situations that can affect the accounting treatment for the client's leases. For example, as a result of 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*.

Troubled Debt Restructurings and Bankruptcy Reorganizations

.112 Some retailers have been in the news lately announcing debt restructurings, and bankruptcy reorganizations. Given the occurrence of these events and their inherently complicated nature, we have provided information below to remind you of the accounting requirements for companies involved in troubled debt restructurings and bankruptcy reorganizations. Also presented are some useful disclosure examples.

Troubled Debt Restructurings

.113 FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (FASB, *Current Text*, vol. 1, sec. D22) as amended, provides the primary guidance on accounting for troubled debt restructurings. The debtor's accounting for a troubled debt restructuring depends upon the kind of restructuring. For example, the arrangement could be a transfer of assets, a grant of equity, a modification of terms, or a combination of those kinds. In addition to the accounting requirements, FASB Statement No. 15, as amended, mandates debtors to make certain disclosures about their troubled debt restructurings.

.114 You may also need to be familiar with the guidance contained in EITF Issue No. 89-15, *Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties* (FASB, *EITF Abstracts*), FASB Technical Bulletin 80-2, *Classification of Debt Restructurings by Debtors and Creditors* (FASB, *Current Text*, vol. 1, sec. D22), and FASB Technical Bulletin 81-6, *Applicability of Statement 15 to Debtors in Bankruptcy Situations* (FASB, *Current Text*, vol. 1, sec. D22).

Bankruptcy Reorganizations

.115 AICPA SOP 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* (AICPA, *Technical Practice Aids*, vol. 2, sec. 10,460) provides guidance on financial reporting by entities that reorganize under Chapter 11 of title 11 of the U.S. Bankruptcy Code. SOP 90-7 distinguishes between financial reporting by the entity during the reorganization proceeding and financial reporting after the plan is confirmed by the court. The principal reporting problem during the proceeding is the measurement of liabilities subject to compromise. The principal reporting problem after the plan is confirmed is the allocation of the reorganization value to the assets of the entity. Determining the appropriate accounting in accordance with SOP 90-7 for entities in reorganization under the Bankruptcy Code requires considerable judgment. You should ensure that appropriate expertise is available in these situations.

Helpful Disclosure Examples

.116 Presented below are examples of financial statement disclosures that concern entities involved with a bankruptcy reorganization.

Example of Financial Statement Disclosure of Reorganization.

On [date], the Company's Second Amended Plan of Reorganization (the Plan of Reorganization) was confirmed by the United States Bankruptcy Court for the District of [place] (Case No. xx-xxx) (the Bankruptcy Court). None of the Company's foreign-based subsidiaries were part of the chapter 11 filing.

By its terms, the Plan of Reorganization becomes effective (*the Effective Date*) on the first business day that is at least ten days after the Bankruptcy Court order confirming the Plan of Reorganization is entered and on which no stay of such order is then in effect. On [date], the Bankruptcy Court entered its order confirming the Plan of Reorganization. Accordingly, the Effective Date of the Plan of Reorganization is [date].

On [date] (*the Filing Date*) the Company filed a voluntary petition (*the Chapter 11 Case*) under chapter 11 of the United States Bankruptcy Code. On [date], the Company filed an amended plan of reorganization and related disclosure statement with the Bankruptcy Court. On [date], the Bankruptcy Court approved as adequate the Disclosure Statement, thereby enabling the Company to solicit votes on the Plan of Reorganization from the Company's secured lenders (collectively, *the Lender Group*) and stockholders. From the Filing Date until the Effective Date, the Company operated its business as a debtor-in-possession subject to the jurisdiction of the Bankruptcy Court. During such time, all claims against the Company in existence prior to the Filing Date were stayed and have been classified as "liabilities subject to compromise" in the consolidated balance sheet.

At [date], "liabilities subject to compromise" were comprised of the following:

[list]

Example of "Basis of Presentation" Disclosure in Significant Accounting Policies Footnote, Related to a Bankruptcy Reorganization.

On [date], with the approval of all voting classes of creditors and equity holders, the United States Bankruptcy Court for [location] confirmed the Debtor's Modified Amended Consolidated Plan of Reorganization dated [date] [*the plan*]. On [date], the plan became effective. For accounting purposes, the effective date of the plan is considered to be [date].

Upon emergence from its Chapter 11 proceedings, the Company issued new common stock, warrants to purchase common stock and senior notes, and created a newly formed liquidating subsidiary, [name], which issued certain asset proceeds notes to be redeemed from the proceeds of sales of noncore assets.

The Company adopted fresh-start reporting in accordance with AICPA Statement of Position No. 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*, as of [date]. The Company's emergence from its Chapter 11 proceedings resulted in a new reporting entity with no retained earnings or accumulated deficit as of [date]. Accordingly, the Company's consolidated financial statements for periods prior to [date] are not comparable to consolidated financial statements presented on or subsequent to [date]. A black line has been drawn on the accompanying consolidated financial statements to distinguish between the pre-reorganization and post-reorganization company.

Special Customer Programs

.117 To confront dwindling consumer demand and the weak economy, many retailers are increasingly offering special incentives to customers. Auditors should inquire whether a client has offered any incentives. Recently, the FASB EITF has been discussing issues relating to certain sales incentives. The following EITF issues relate to the accounting for sales incentives and should be considered:

- EITF Issue No. 00-14, *Accounting for Certain Sales Incentives* (Consensuses were reached May 17-18, 2000, with revisions made to the EITF Abstracts at the September 20-21, 2000 meeting.)
- EITF Issue No. 00-21, *Accounting for Multiple-Element Revenue Arrangements* (Consensuses were reached July 19, 2001, with revisions to the EITF Abstracts at the July 19, 2001 meeting.)
- EITF Issue No. 00-22, *Accounting for "Points" and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future* (Originally discussed at the September 20-21, 2000 meeting, consensuses reached on Issue 3 January 17-18 2001, further discussion is planned at future meetings.)

.118 Auditors should also consider the guidance in SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU secs. 310, 333, and 380), when evaluating whether such sales incentives have been properly accounted for. SAS No. 89 establishes audit requirements designed to encourage client management to record financial statement adjustments aggregated by the auditor.

Employee Layoffs

.119 Many companies are instituting layoffs during this economic downturn. Since January 2001, announcements of job cuts just keep coming. U.S. companies have reported approximately 650,000 layoffs through May 2001. The trend is broad-based, affecting not just struggling industries like tech and telecom but also food and consumer products—both businesses once thought to be recession-proof. Healthy companies are also using layoffs as a tool to reduce costs and accumulate earnings as they maneuver through this economic downturn.

.120 If the retailing entity you are auditing is experiencing layoffs, management will need to properly account for employee-related termination charges such as severance packages, restructuring charges, and voluntary separation. In addition, management may need to properly account for outplacement services, bonuses, and educational allowances to assist employees in contending with the loss of their jobs. The following accounting literature provides guidance on accounting issues related to layoffs:

- EITF Issue No. 94-3 addresses liability recognition for certain employee termination benefits. See the "Store Closings, Restructuring Charges, and Asset Impairments" section of this Alert for further information about the guidance in EITF Issue No. 94-3.
- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, establishes standards for accounting for curtailments and termination benefits among other issues. Practitioners should refer to paragraphs 6 to 14 for guidance on curtailment and paragraphs 15 to 17 for guidance on termination benefits. FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits other than Pensions*, requires the effect of the curtailment

(for example, the termination of employees' services earlier than expected, which may or may not involve closing a facility or discontinuing a segment of a business) to be recorded as a loss. Practitioners should refer to paragraphs 96 to 99 for guidance on how to account for plan curtailment. The Statement also provides guidance on how to measure the effects of termination benefits in paragraphs 101 and 102.

- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, requires that entities providing postemployment benefits to their employees accrue the cost of such benefits. Inactive employees include those who have been laid-off, regardless of whether or not they are expected to return to work. Postemployment benefits that can be attributed to layoffs can include salary continuation, supplemental unemployment benefits, severance benefits, job training and counseling, and the continuation of benefits such as health care benefits and life insurance coverage.

FASB Statement No. 112 does not require that the amount of postemployment benefits be disclosed. The financial statement shall disclose if an obligation for postemployment benefits is not accrued because the amount cannot be reasonably estimated.

- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, addresses disclosures only and requires the disclosure of the amount of gain or loss recognized resulting from a settlement or curtailment. Additionally, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event is required to be disclosed.

Subsequent Events

.121 Auditors should also refer to AU Section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560), for guidance on auditors' procedures relating to subsequent events. The following audit procedure should be applied to employee benefit plan engagements that include terminations. The auditor should inquire of and discuss with the plan administrator or other parties performing the plan's management function matters involving unusual terminations of participants, such as terminations arising from a sale of a division or layoffs.

Internal Control Deficiencies and Audit Processes

.122 Significant layoffs can have a serious effect on a retailer's internal control and financial reporting and accounting systems. For instance, employees who remain at the company may be overwhelmed by their workloads, under pressure to complete their tasks with little or no time to consider their decisions, or performing too many tasks and functions. The auditor may need to consider whether these situations exist and what their effect is on internal control.

.123 Additionally, the auditor may need to consider the possible effects that key unfilled positions can have on internal control. Retailers that have had strong financial reporting and accounting controls could see those controls deteriorate as a result of the lack of employees. Controls over inventory, purchasing, and receivable collections could also suffer. Layoffs can also create additional exposure to possible internal fraudulent activities (for example, when an employee performs job functions that otherwise would be segregated.)

.124 You may want to consider these issues in planning and performing the audit and in assessing control risk. Remember that gaps in key positions may cause control weaknesses representing reportable conditions that should be communicated to management and the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

Accounting for Advertising Costs

How should management account for advertising costs?

.125 Retailers advertise through newspaper inserts, local television, circulars, magazines and radio spots, which can take a big chunk out of their budgets and bottom lines. In the beginning of the year and now,

advertising has been used to help retailers with promoting markdowns for slow moving merchandise in an effort to keep inventory at a healthy level. Currently, retailers will use advertising to promote back-to-school sales, to target consumers receiving tax rebates, and to possibly develop a competitive edge in the upcoming holiday season. Practitioners should refer to SOP 93-7, *Reporting on Advertising Costs*, for guidance.

.126 SOP 93-7 defines advertising as a customer acquisition activity involving the promotion of an industry, an entity, a brand, a product name, or specific products or services so as to create or stimulate a positive entity image, or to create or stimulate a desire to buy the entities' products or services. It also provides guidance on accounting for advertising costs in annual financial statements for the following:

- a. Reporting the costs of advertising, which would be expensed either as incurred or the first time the advertising takes place, except for direct-response advertising:
 - (1) That is primarily intended to elicit sales to customers who could be shown to have responded specifically to the advertising.
 - (2) That results in probable future economic benefits.
- b. For direct-response advertising that may result in reported assets (that is, capitalized pursuant to the criteria set forth in items (1) and (2) above) as follows:
 - (1) How such assets should be measured initially
 - (2) How the amounts ascribed to such assets should be amortized
 - (3) How the realizability of such assets should be assessed

Additionally, SOP 93-7 requires that the notes to the financial statements should disclose the following:

- a. The accounting policy for reporting advertising, indicating whether such costs are expensed as incurred or the first time the advertising takes place
- b. A description of the direct-response advertising reported as assets (if any), the accounting policy for it, and the amortization period
- c. The total amount charged to advertising expense for each income statement presented, with separate disclosure of amounts, if any, representing a write-down to net realizable value
- d. The total amount of advertising reported as assets in each balance sheet presented

.127 The following is an example of the disclosures required by the SOP:

Note X. Advertising

The Company expenses the production costs of advertising the first time the advertising takes place, except for direct-response advertising, which is capitalized and amortized over its expected period of future benefits.

Direct-response advertising consists primarily of magazine advertisements that include order coupons for the Company's products. The capitalized costs of the advertising are amortized over the three-month period following the publication of the magazine in which it appears.

At December 31, 20XX, \$1,000,000 of advertising was reported as assets. Advertising expense was \$10,000,000 in 20XX, including \$500,000 for amounts written down to net realizable value.

Auditing and Attestation Pronouncements and Guidance Update

.128 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. The AICPA *Audit Risk Alert*—2001/02 [AAM section 8010] contains a summary explanation of all these issuances. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

.129 To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 94	<i>The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit</i>
SOP 01-3	<i>Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law</i>
SSAE No. 10	<i>Attestation Standards: Revision and Recodification</i>
Audit Guide	<i>Auditing Derivative Instruments, Hedging Activities, and Investments in Securities</i>
Audit Guide	<i>Auditing Revenue in Certain Industries</i>
Audit Guide	<i>Audit Sampling</i>
Audit Guide	<i>Analytical Procedures</i>
Practice Alert 01-1	<i>Common Peer Review Recommendations</i>

Accounting Pronouncements and Guidance Update

.130 Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. The AICPA *Audit Risk Alert*—2001/02 [AAM section 8010] contains a summary explanation of all these issuances. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 141	<i>Business Combinations</i>
FASB Statement No. 142	<i>Goodwill and Other Intangible Assets</i>
FASB Statement No. 143	<i>Accounting for Asset Retirement Obligations</i>
FASB Statement No. 144	<i>Accounting for the Impairment or Disposal of Long-Lived Assets</i>
FASB Technical Bulletin No. 01-1	<i>Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets</i>
SOP 00-3	<i>Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts</i>
SOP 01-1	<i>Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools</i>
SOP 01-2	<i>Accounting and Reporting by Health and Welfare Benefit Plans</i>
AICPA Audit and Accounting Guide	<i>Audits of Investment Companies</i>
Questions and Answers	<i>FASB Statement No. 140</i>

On the Horizon

.131 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is some brief information about some ongoing projects that are especially relevant to the Retail industry. Remember that exposure drafts are non-authoritative and cannot be used as a basis for changing GAAP or GAAS. The AICPA general *Audit Risk Alert—2001/02* [AAM section 8010] summarizes some of the more significant exposure drafts outstanding.

.132 The following table lists the various standard-setting bodies' web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft.

<i>Standard Setting Body</i>	<i>Web site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
FASB	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft email list" in the subject header field to help process the submissions more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

New Framework for the Audit Process

.133 The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB expects to issue a series of exposure drafts in late 2001 and 2002. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

.134 Some of the more important changes to the standards that are expected to be proposed are:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Among other things, this will improve the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit.
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures.

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

.135 You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Resource Central

Educational courses, Web sites, publications, and other resources available to CPAs

On the Book Shelf

.136 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- *Auditing Derivative Instruments, Hedging Activities and Investments in Securities* Audit Guide (Product No. 012520kk)
- *Auditing Revenue in Certain Industries* Audit Guide (Product No. 012510kk)
- *Audit Sampling* Audit Guide (Product No. 012530kk)
- *Analytical Procedures* Audit Guide (Product No. 012551kk)
- *Auditing Estimates and Other Soft Accounting Information* Practice Aid (Product No. 010010kk)
- *Accounting Trends & Techniques—2001*
- *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* Practice Aid (Product No. 006701kk)
- *Consideration of Internal Control in a Financial Statement Audit* 1997 (Product No. 012451kk)
- *Use of Real Estate Appraisal Information* 1997 (Product No. 013159kk)
- *Common Interest Realty Associations Checklist* (Product No. 008764kk)
- *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (Product No. 008883kk)

Audit and Accounting Manual

.137 The *Audit and Accounting Manual* (Product No. 005131kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs; auditors' reports; checklists; engagement letters, management representation letters, and confirmation letters.

CD-ROM

.138 The AICPA is currently offering a CD-ROM product titled *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 that includes all Guides and the related Audit 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.

Educational Courses

.139 The AICPA has developed a number of continuing professional education courses that are valuable to CPAs working in the specific industries. Those courses include:

- *AICPA's Annual Accounting and Auditing Workshop* (2000-2001 Edition) (Product No. 737061 (Text); 187078 (Video)). Whether you are in industry or public practice, this course keeps you current, informed, and shows you how to apply the most recent standards.
- *Independence* (Product No. 739035). This new interactive CD-ROM course will review the AICPA authoritative literature covering independence standards (including the newly issued SECPS independence requirements), SEC regulations on independence, and Independence Standards Board standards.
- *Internal Control Implications in a Computer Environment* (Product No. 730617). This practical course analyzes the effects of electronic technology on internal controls and provides a comprehensive examination of selected computer environments, from traditional mainframes to popular personal computer setups.

Online CPE

.140 The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee (\$95 for members and \$295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today as our guest at infobytes.aicpaservices.org.

CPE CD-ROM

.141 *The Practitioner's Update* (Product No. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

.142 To order AICPA products, receive information about AICPA activities, and find help on your membership questions call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.143 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.144 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.

Web Sites

AICPA Online

.145 AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as

developments in congressional and political affairs affecting CPAs. In addition, AICPA Online offers information about AICPA products and services, career resources, and online publications.

CPA2Biz.Com

.146 This new Web entity is the product of an independently incorporated joint venture between the AICPA and state societies. It currently offers a broad array of traditional and new products, services, communities and capabilities so CPAs can better serve their clients and employers. Because it functions as a gateway to various professional and commercial online resources, cpa2biz.com is considered a Web “portal.”

.147 Some features cpa2biz provides or will provide include:

- Online access to AICPA products like audit and accounting guides, and audit risk alerts
- News feeds each user can customize
- CPA “communities”
- Online CPE
- Web-site development and hosting
- Electronic procurement tools to buy goods and services online
- Electronic recruitment tools to attract potential employees online
- Links to a wider variety of professional literature
- Advanced professional research tools

Other Helpful Web Sites

.148 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of this section.

.149 This Audit Risk Alert replaces *Retail Industry Developments—2000/2001*.

.150 Practitioners should also be aware of the economic, regulatory, and professional developments described in *Audit Risk Alert—2001/02* [AAM section 8010] and *Compilation and Review Alert—2001/02* [AAM section 8015] which may be obtained by calling the AICPA Order Department at (888) 777-7077.

.151 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 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 e-mail these comments to lwest@aicpa.org or write to—

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Appendix

The Internet—An Auditor's Research Tool

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, IRS 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, and are generally 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 as follows:

- 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. The reliability of the information obtained via the Internet 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.

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	www.aicpa.org
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
Securities and Exchange Commission	SEC Digest and Statements, EDGAR database, current SEC rulemaking	www.sec.gov
Independence Standards Board	Information on the activities of the Independence Standards Board	www.cpaindependence.org
The Electronic Accountant	<i>World Wide Web</i> magazine, which features up-to-the-minute news for accountants	www.electronicaccountant.com

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
CPAnet	Links to other Web sites of interest to CPAs	www.cpalinks.com/
Guide to WWW for Research and Auditing	Basic instructions on how to use the Web as an auditing research tool	www.tetranet.net/users/gaostl/guide.htm
Accountants Home Page	Resources for accountants and financial and business professionals	www.computercpa.com
United States Department of Commerce	Various economic statistics about the U.S. economy	www.doc.gov www.bea.doc.gov
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
Federal Reserve Bank of New York	Key interest rates	www.ny.frb.org/pihome/statistics/dlyrates
Hoovers Online	Online information on various companies and industries	www.hoovers.com
Ask Jeeves	Search engine that utilizes a user-friendly question format. Provides simultaneous search results from other search engines as well (e.g., Excite, Yahoo, AltaVista)	www.askjeeves.com
Chain Store Age	Industry periodical with retail news headlines	www.chainstoreage.com
About	Industry periodical with retail news, trends and statistics	retailindustry.about.com
Today's Retail News	Current events in the retail industry	biz.yahoo.com/news/retail.html

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AAM Section 8160

Auto Dealership Industry Developments—2001/02

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your 2001 year-end audits of dealerships. Although this Alert focuses on the automobile dealership, the topics discussed often can be applied to other types of dealerships, including boats, heavy trucks, farm machinery, and recreational vehicles. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business and economic environment your clients operate in. This Alert is an important tool in helping you identify the significant business risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the dealership industry and you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

.03 This Alert is intended to be used in conjunction with the AICPA *Audit Risk Alert—2001/02* [AAM section 8010].

Economic Developments

.04 With over 19,400 franchised automobile dealerships in the United States, automobile dealerships play a big role in the U.S. economy and in many local communities as well. In auditing a dealership you should be aware of the general economic, regulatory, and professional developments that may affect your client.

.05 The AICPA *Audit Risk Alert—2001/02* [AAM section 8010] contains a summary of general economic conditions, some of which are summarized in this section, along with certain industry-specific information. Keep in mind that 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 type shown may be useful to auditors in applying the provisions of SAS No. 56.

Dealership Results in 2000

.06 Surprisingly, franchised new vehicle dealers had another good year in 2000, despite the slowing of the U.S. economy. Total industry revenue hit another record by reaching more than \$646 billion (up from \$608 billion last year), with more than 17 million new cars and light trucks registered in the United States.¹ The new vehicle department contributed almost 25 percent to total profit at the average dealership. Although this is down from last year's 39 percent, this is still impressive compared to the last decade. Before 1998, dealership profits came mostly from the sale of used vehicles and the service and parts department. The following table shows the breakdown of dealership profits by department over the past three years.

¹ AutoExec magazine, NADA Data 2001 (August 2001), pp. 35–55.

Percentage of Total Dealership Profits

	2000	1999	1998
New vehicle department	25%	39%	29%
Used vehicle department	22%	19%	24%
Service and parts department	53%	42%	47%

.07 In 2000, sales of new vehicles increased 7 percent from 1999 and used vehicle sales increased 6 percent with total sales of 20.5 million used vehicles.² The service and parts department also had a good year with sales up 9 percent over last year. Even with record sales, however, total profit at the average dealership declined due to the increase in floor plan costs. The average dealer's floor plan interest (for the new and used car departments) for the first half of 2000 increased 52 percent over the first half of 1999.³

.08 The trend of the decline of small-volume franchised car dealerships continued in 2000. According to *AutoExec* magazine, in 1981 dealerships with sales of less than 150 new vehicles per year numbered 9,700. Today there are only 3,699 such dealerships (this is down from 4,161 last year). In contrast, today more than 6,400 dealerships sell more than 750 new vehicles per year, whereas fewer than 4,000 such dealerships existed in 1980.⁴

The Current Economic Environment

.09 As of the fourth quarter of 2001, the U.S. economy was weak and its outlook uncertain. Adding further agitation and uncertainty to that weak economic picture are the ramifications of the September 11 attacks upon America. The effects of the attacks are likely to further unhinge consumer confidence, decrease corporate earnings, increase layoffs, and further depress the stock market. To be sure, the short-term economic picture looks grim.

.10 Still, the financial underpinnings of the U.S. economy remain strong. Inflation is contained, interest rates have been cut, taxes have been lowered, energy prices have fallen, and the public debt has diminished. Additionally, in response to the September 11 attacks government stimulus measures are likely to be enacted in the form of increased spending on defense, spending on recovery efforts, direct aid to certain industries, and further tax cuts. The seeds of economic recovery are being sown. So while the health of the economy in the short term is grim and uncertain and will likely continue to worsen, some feel that the economic malaise may be short-lived.

.11 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; 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. Given the interrelationship of automobile sales and the economy, auditors of dealerships will benefit from having an understanding of general economic conditions.

.12 SAS No. 56 requires the use of analytical procedures in the planning and overall review stages of all audits. The following key statistics relating to the overall performance of the U.S. economy may be useful to auditors in applying the provisions of SAS No. 56. It is important to point out however that in the wake of the September 11 attacks, the traditional indicators that many economists use to gauge the movement of the economy may be rendered useless in the short term. The effects of the September 11 attacks on the economy won't be known for some time.

² See footnote 1.

³ *AutoExec* magazine, October 2000, p. 25

⁴ *AutoExec* magazine, NADA Data 1995, p. 29; and NADA Data 1998 and NADA Data 2001.

- Gross domestic product (GDP)—which measures the output of goods and services produced by labor and property located in the United States—increased 1.3 percent in the first quarter. GDP barely grew in the second quarter of 2001, increasing slightly by .3 percent. This was the slowest performance in eight years. Prior to September 11, all indications were that the economy would continue to stagnate in the third quarter; instead third quarter GDP fell .4 percent, the first drop in GDP since 1993. Estimates for fourth quarter GDP point to a 1 percent or more decline. Some define a recession as a decline in GDP for two consecutive quarters thereby suggesting that the U.S. is entering a recession. In fact, the National Bureau of Economic Research establishes the official date of when a recession occurs based on the decline of several economic indicators, not just GDP.
- Consumer confidence,⁵ a key predictor of household spending, fell sharply in September 2001 to 97.6 from 114 in August. October 2001 saw consumer confidence at its lowest level in seven years, down to 85.5, with expectations for the next six months very dim. Still this level is higher than the 60 points consumer confidence was at during the Gulf War. Historically, there appears to be a strong relationship between consumer confidence and automobile sales, not boding well for dealers. However the current manufacturer incentives have helped to keep sales strong since September 11.
- Unemployment increased to 4.9 percent in August 2001 and remained steady at that level in September. In October 2001 unemployment jumped to 5.4 percent; this is the highest level it has been at since December 1996, reflecting the effects of September 11. Dealerships continue to play a major role in the nation's employment. In 2000 the payroll for all dealerships combined represented 11 percent of the nation's total retail trade payroll.⁶
- Interest rates have been cut 10 times this year—the fastest series of interest rate cuts seen in the past 14 years. On November 6, 2001, the federal funds rate (the interest rate at which banks lend to each other overnight) was reduced another half-point to 2 percent—this is down from 6.5 percent in the third quarter of 2000. By the end of the third quarter 2001, the prime rate (the rate many banks charge their top customers and to which other interest rates are often linked) was down to 6 percent and then was lowered again in October to 5.5 percent—the lowest it has been since 1972. The prime rate is down from 9 percent a year ago. Mortgage rates have also declined to under 7 percent from just six months ago. Mortgage rates are at their lowest in three years.

The Local Economy

.13 In addition to the national economy, auditors should also consider the local economy. Significant local developments may affect dealership performance. Plant closings and layoffs by major employers can send local economies into a tailspin. Certain regions may also be vulnerable to economic downturns in major local industries, whereas 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 also negatively affected.

Layoffs

.14 The economic decline has been accompanied by major layoffs throughout many industries. Even healthy companies are using layoffs as a tool to reduce costs and accumulate earnings as they maneuver through this economic downturn.

.15 Significant layoffs can have a serious effect on an entity's internal control and financial reporting and accounting systems. For instance, employees who remain at the company may feel overwhelmed by their workloads, feel pressure to complete their tasks with little or no time to consider their decisions, and may be performing too many tasks and functions. The auditor may need to consider whether these situations exist and what their effect is on internal control.

⁵ As measured by the Conference Board. See www.conferenceboard.org for further information.

⁶ AutoExec magazine, NADA Data 2001, p. 48.

.16 Additionally, the auditor may need to consider the possible effects that key unfilled positions can have on internal control. Entities that have had strong financial reporting and accounting controls could see those controls deteriorate due to the lack of employees. Layoffs can also create additional exposure to possible internal fraudulent activities (for example, when an employee performs a job function that otherwise would be segregated).

.17 You may want to consider these issues in planning and performing the audit and in assessing control risk. Remember that gaps in key positions may cause control weaknesses representing reportable conditions that should be communicated to management and the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

Industry Developments and Other Issues

The following sections touch on how dealerships have fared in 2001 so far and what new obstacles they face.

.18 The automobile industry continues to be a highly saturated, mature industry with intense competition. The makeup of the automobile industry is changing, perhaps forever. The U.S. domestic car makers have been hit hardest by the slowing of the U.S. economy and the “Big Three” U.S. car makers (General Motors, Ford, and the Chrysler unit of Daimler-Chrysler) are quickly losing their market share to foreign competitors. While sales continue to decline for the domestic car makers, some of the foreign car makers are doing well, especially in the sport-utility, pickup, and minivan areas. At one time U.S. car makers held over 70 percent of sales in the U.S. car market. In August 2001 sales at the Big Three car companies fell below 60 percent of all new cars and trucks sold. It is believed that as their market share continues to erode, the U.S. car market may one day be dominated by foreign brands.

.19 This section discusses various threats, competitors, and other industry issues that may be relevant to auditors of dealerships. The following standards should be considered when auditing dealerships:

- SAS No. 22, *Planning and Supervision* (AICPA, *Professional Publications*, vol. 1 AU sec. 311), states that, when planning an audit, the auditor should consider other matters, such as accounting practices common to the industry, competitive conditions, and if available, financial trends and ratios.
- SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), 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. Keep in mind that when risk factors are identified, professional judgment should be exercised in assessing their significance and relevance (see SAS No. 82 for a list of fraud risk factors).
- Auditors should also keep in mind their responsibilities 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). SAS No. 59 discusses the auditor’s responsibilities with respect to evaluating whether there is substantial doubt about an entity’s ability to continue as a going concern. Some external matters cited by SAS No. 59 that indicate there could be substantial doubt about the entity’s ability to continue as a going concern when considered in the aggregate include loss of a key franchise and loss of a principal customer or supplier.

How Are Dealerships Doing in 2001?

.20 Dealerships are still seeing strong sales in 2001, although it is believed that 2001 will not be able to beat the record sales of the past few years. The strong level of sales throughout 2001 is being linked to the numerous manufacturer incentives that were offered, especially by the domestic car dealers. Sales estimates

prior to September 11 estimated total sales of just over 16.5 million vehicles. At first, sales of vehicles after September 11 were estimated to fall below the 16.5 million mark, however further manufacturer incentives have helped to spur record sales in October 2001. Since September 11 many domestic car dealers have offered new incentives linked to “patriotic” themes to help spur sales through the end of the year. While this has helped boost sales in the short-term, dealerships should be prepared for when these incentives are no longer offered. It is believed that the manufacturers may not be able to keep offering incentives as sales decline and cut into their profits.

September 11, 2001

.21 While sales of vehicles were already slowing down, the September 11 attacks on the World Trade Center and the Pentagon brought vehicle sales screeching to a halt. Sales declined almost 30 percent in the first couple of days after the attacks. Sales then rebounded through the end of the month due mainly to the zero percent financing program incentives that the Big 3 auto makers offered—helping to bring consumers back into the showrooms. In October 2001 a record of 1.73 million new light vehicles were sold. Sales of light vehicles are now expected to reach 16.8 million for the year. This level of sales would make 2001 the third best year ever. Forecasts for 2002 show sales falling below 16 million vehicles.

Operating in a Downturn

.22 In the wake of the September 11, 2001, terrorist attacks against America it seems more likely than ever that sales of new vehicles will be slowing. Naturally, many are concerned that America is headed for an economic recession. The automobile industry is vulnerable to economic swings and therefore is cyclical in nature. This makes us look to the past to see how dealerships have performed in difficult economic times.

Some History

.23 Total domestic car and light truck sales exploded during the mid 1980s, growing from a modest 10.05 million units in 1982 to a peak of 16.08 million units in 1986.⁷ In contrast, the late 1980s was marked by substantial declines. Sales declined from 1988 through 1991, reaching an eight-year low of 12.4 million units in 1991.⁸ Keep in mind that this decline coincided with the Gulf War. The industry began to rebound in 1992. The recovery in that year was relatively modest, which was consistent with the overall economy. During the lean years, many dealers struggled to survive. Faced with narrowing gross margins, these dealers reduced inventory, scaled back promotional expenses, and laid off employees to reduce overall expenses. Despite these efforts, according to *AutoExec* magazine, in 1990 and 1991 “... more than 20% of dealerships lost money, and nearly 1,500 went out of business.”⁹

What About Today?

.24 We are seeing some similarities in the way dealers are handling the current economic slowdown. Dealers are looking for ways to cut costs and to preserve their profits. Some dealers are trying to restructure their advertising, to get control of new and used inventory, and to control energy consumption. When the economy slows dealers attempt to shorten their vehicle turnover, for example to shorten it from 60 days to 45 days. Also look for dealerships to reduce head count and streamline advertising.

.25 J.D. Power and Associates released a report recently saying that although new vehicle sales fell sharply immediately after September 11, they expect sales to be less than last year but still the third best year on record. Manufacturers are doing their part in trying to spur on the sales of new vehicles. GM, Ford, and

⁷ Automotive News, 1995 Market Data Book, May 24, 1995, p. 25; 1992 Market Data Book, May 27, 1992, p. 17.

⁸ Automotive News, 1992 Market Data Book, May 27, 1992, p. 17.

⁹ AutoExec magazine, 1992 NADA Data Book, August 1992, p.24.

others offered new incentives to help raise the demand for new vehicles and to get Americans back to purchasing new cars. Dealers believed they would be affected first by the declining sales as they had already ordered their inventory for the remainder of 2001, however after record sales in October 2001, dealers' inventory levels are significantly less than inventory levels a year ago. Many believe that while the new incentives have helped sales now, the first part of 2002 will see tough times for the industry.

Audit Implications

.26 The declining business environment that auto dealerships are currently operating in presents business risks that could result in material misstatements to the financial statements. Issues that auditors may want to consider include:

- Going concern (consider guidance in SAS No. 59)
- Increased competitive environment and the pressure it places on management (see the section "Increased Competition" in this section of the Alert)
- Layoffs and their effect on internal control and related accounting issues (see the discussion of "Layoffs" in "The Current Economic Environment" section of this Alert)
- Increased risk of fraudulent financial reporting (consider guidance in SAS No. 82)

The Role of the Internet

.27 The Internet, once thought to be a major threat, has proven to be an asset to the dealers. The past year has shown that consumers want and need the bricks-and-mortar dealerships for many reasons, including to test drive and service their cars. This past year has seen the demise and consolidation of many auto dot-com companies. Most consumers use the Internet as a resource and a research tool but do the actual purchasing at the dealership. The Internet has changed the way dealerships operate. Dealerships now use the Internet for business-to-business and business-to-consumer purposes. Currently, 94 percent of dealerships have a Web site and 78 percent of dealerships use the Internet for business operations.¹⁰ Many dealers are using the Internet for vehicles, parts, and warranty claims. They can now order, trade, or locate cars online. These Internet-based systems allow for access to dealer data, dealer-factory communications, and competitive sales data. Dealers may face certain exposures when conducting business via the Internet. Such exposures include unauthorized access to or theft of data, computer viruses, and unauthorized transactions. The use of the Internet by dealers raises numerous accounting and auditing issues that should be considered by auditors.

Help Desk—For a thorough discussion of e-business issues and risks including audit and accounting concerns see the Audit Risk Alert *E-Business Industry Developments—2001/02* [AAM section 8210].

Increased Competition

.28 An unlikely competitor to the dealerships is now in the form of other independent service stations trying to win over the service of vehicles from dealerships. The profits from the service and parts departments contributed 53 percent to total dealership profits in 2000. Dealerships will be competing with independent service stations in the future for fewer repairs as the quality of vehicles increases.

Audit Implications

.29 The increasing competition from independent service stations generates more intense pressure on management to perform and meet earnings and revenue expectations. Some specific matters auditors should

¹⁰ A recent study by Autodata. NADA's AutoExec magazine, June 2001, p. 39.

be concerned with when auditing a client subject to intense pressures include the risk of material misstatement due to fraud, aggressive accounting methods, and internal control weaknesses.

.30 *Risk of Material Misstatement Due to Fraud.* SAS No. 82 points out the following factors that may indicate an increased risk of fraudulent financial reporting at an entity:

- High degree of competition or market saturation, accompanied by declining margins
- An excessive interest by management in maintaining or increasing the entity's earnings trend through the use of unusually aggressive accounting practices
- Management setting unduly aggressive financial targets and expectations for operating personnel
- Significant pressure to obtain additional capital necessary to stay competitive, considering the financial position of the entity
- Unrealistically aggressive sales or profitability incentive programs

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.

.31 *Aggressive Accounting.* To achieve expected results or report improved financial results, management may adopt aggressive accounting positions. Auditors should be alert to aggressive accounting positions taken by management and determine whether the accounting is appropriate under the circumstances.

.32 *Overriding Internal Control.* Management of a dealership engaged in a severely competitive environment may aggressively engage in transactions that bypass normal internal control. 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.

Relationships With Factories

.33 The National Automotive Dealers Association (NADA) continues to focus its efforts on industry relations. Last year's Alert discussed the rise in factory-owned dealerships. In 2000, we saw a retreat by the manufacturers in establishing their own Web sites and trying to sell directly to consumers. In many cases franchise laws have protected the traditional dealerships. In fact, Ford announced that by the end of the year it would sell many of its manufacturer-owned auto dealerships.

.34 The relationship between dealers and their factories¹¹ continues to be contentious. With the Ford recalls, the discontinuance of Oldsmobile, and the Blue Oval program there was a lot for domestic car dealers to be upset about.

.35 Auditors should pay attention to the factory-dealer relationship because it can have a tremendous impact on the dealership. In some cases, adverse relationships may affect the dealership's ability to continue as a going concern—for instance, if the discontinuance of a certain brand of vehicle plays a large roll in the profitability of a dealership or if a dealer cannot meet customer demands because it is unable to obtain certain types of vehicles from the factory. In reviewing such relationships, auditors should be aware of their responsibilities pursuant to SAS No. 59. SAS No. 59 says that ordinarily information that significantly

¹¹ For the purposes of this section, the word factories is synonymous with manufacturers.

contradicts the going-concern assumption includes the inability to continue to meet obligations as they become due without substantial disposition of assets outside the ordinary course of business, externally forced revisions of operations, or similar actions. Auditors also should consider whether management has made appropriate financial statement disclosures of concentrations in the available source of supply materials pursuant to Statement of Position (SOP) No. 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

.36 The following discusses some of the more prominent conflicts between dealers and manufacturers.

Ford

.37 Relations between Ford and its dealers continued to be strained this year. You could not pick up a newspaper without reading about the Ford-Firestone recalls. To this day there is still “finger pointing” going on between Ford and Firestone. The dealers have concerns about how Ford has handled this crisis. Dealers are dependent upon their manufacturer to help support the products they sell. The Ford-Firestone situation has caused dealers to question Ford’s financial health, future product programs, and quality incentives. Ford dealerships have seen their sales and their profitability decline due to these recalls. In August Ford said it would take a \$900 million hit against earnings for restructuring including cutting 5,000 jobs. In addition the charge includes the selling of manufacturer-owned dealerships, and the write-down of electronic-commerce investments. Further, Ford has to deal with the decline in sales, the decline in market share, lower ratings on vehicle quality, and tire safety litigation.

.38 Ford’s Blue Oval program has also come under much criticism and is an area of contention between Ford and its dealers. The Blue Oval program is a customer satisfaction program that pays dealers an incentive for meeting certain customer service standards. Many dealers feel that this program is discriminatory and that the potential exists for some dealers to be at a competitive disadvantage. At the time of the writing of this Alert, North Carolina’s legislature was considering a bill that would ban the incentive tied to the Blue Oval program because of price discrimination. The bill was with a conference committee to settle a dispute concerning when the legislation should take effect. Be alert to the passing of this bill as it may spur on other states to follow suit.

General Motors

.39 Ford is not the only automobile manufacturer to have strained relations with its dealers. The announcement this year by GM that it would discontinue the Oldsmobile brand has left many dealers shaken. Some dealers feel that the announcement to discontinue the Oldsmobile has violated the existing franchise agreements by cutting the value of Oldsmobile to the public. Many Oldsmobile dealers believe that the buyout package that GM is offering is not adequate and that many dealers will be forced out of business. The possibility for a legal battle between GM and the Oldsmobile dealers exists.

.40 Other conflicts occurred when GM said it would enforce a franchise agreement requiring GM approval for any dual franchises. GM plans to sue dealers who refuse to move non-GM brands of vehicles out of their showrooms. GM also has problems with its dealers on the new ordering system. Many dealers have found the system very complex and time-consuming, putting more pressure on dealers and making more demands of them. This again shows the fragile relationship between dealers and manufacturers.

Chrysler

.41 Chrysler is not immune to conflict with its dealers. In taking cost-cutting steps to restore the company’s financial health, Chrysler has angered many of its dealers. Such steps as shipping cars to dealers without a full tank of gas, cutting funding for advertising and technology improvements at dealerships, and paying dealers less to get cars prepped for the showroom leave the dealers feeling that Chrysler is taking money out of their pockets.

Money Laundering

What should you know about money laundering?

.42 Money laundering¹² is the funneling of cash or other funds generated from illegal activities through legitimate financial institutions (and automobile dealerships are defined as nonbank financial institutions by the Bank Secrecy Act¹³) or other 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 boundaries. Current estimates of the size of the global annual “gross money laundering product” range from \$500 billion to \$1.5 trillion.¹⁴

.43 Criminals use a wide variety of bank and nonbank financial institutions and professional advisers to launder the proceeds of crime, and according to the U.S. Department of Treasury, auto dealerships and dealers in boats and aircraft may also be vulnerable. 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 automobile dealership industry may become increasingly vulnerable to money laundering and more attractive to money launderers.

.44 Although automobile dealerships are not subject to specific anti-money laundering regulations under the Bank Secrecy Act, regulations issued by the Internal Revenue Service (IRS) require these businesses to report the receipt of currency and certain monetary instruments that exceed \$10,000. Section 6050I of the Internal Revenue Code requires that any person who, in the course of engaging in a trade or business, receives more than \$10,000 in cash or, in some instances, monetary instruments, in a single transaction or two or more related transactions, must file a report describing the transaction or transactions.¹⁵ This requirement does not apply to transactions that are reported under the Bank Secrecy Act to avoid duplicate reporting of the same transaction.

.45 As 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.

.46 *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 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 in order to keep their proceeds concealed, their methods secret, and their identities and professional resources anonymous. A common placement technique is to purchase expensive luxury goods, often through structuring¹⁶ payments of illicitly obtained cash and cash equivalents.

.47 *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 electronic fund transfers, usually directly or subsequently transacted with a “bank secrecy haven” or a jurisdiction with more liberal recordkeeping and reporting requirements; withdrawals of already-placed

¹² This section of the Alert was drafted after consultation with the U.S. Department of the Treasury. As such, it provides auditors with a unique insight into how federal regulators view this important area of concern.

¹³ 31 U.S.C. 315312(a)(2)(T).

¹⁴ By definition, money launderers are in the business of cloaking their activities and revenue, making this approximation difficult.

¹⁵ See 26 U.S.C. 6050I. The report must include the following information: the name, address, and taxpayer identification number of the person from whom the cash was received; the amount of cash received; the date and nature of the transaction; and such other information as may be prescribed by rule.

¹⁶ Structuring means breaking up large amounts of currency into smaller amounts to conduct transactions in such a manner to avoid currency reporting or other regulatory requirements.

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 or policy holder appears to have no obvious relationship.

.48 *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.

.49 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 far less likely to be detected in a financial statement audit than other types of illegal activities. In addition, money laundering activity is more likely to cause assets to be overstated rather than understated, with shorter-term fluctuations in account balances rather than cumulative changes. 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.

.50 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.

.51 In June 2000, the OECD's Paris-based Financial Action Task Force (FATF), the world's anti-money laundering watchdog intergovernmental organization, issued a *Review to Identify Non-Cooperative Countries or Territories*, expressly identifying 15 governments as noncooperative with other countries and jurisdictions in combating money laundering. Subsequently, in July, the U.S. Treasury Department followed suit with a series of Financial Crimes Enforcement Network (FinCEN) country advisories, which asked U.S. businesses to pay closer attention to transactions linked to these countries. During 2001, several of these jurisdictions were removed from the noncooperative lists and new ones added.

.52 For more information about the EITF, see the AICPA *Audit Risk Alert*—2001/02 [AAM section 8010].

.53 The AICPA Audit and Accounting Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk) is helpful in explaining what swaps are and how to audit them.

Help Desk—A description of federal regulations pertaining to money laundering appears in this Alert's *appendix*, "Federal Money Laundering Regulations."

Audit and Accounting Issues and Developments

Swaps and the Dealership

.54 Some dealerships may be using swaps as a means of managing financing costs. What are swaps and how do they work?

.55 The AICPA Audit and Accounting Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, new edition as of March 15, 2001, defines a swap as follows:

Swap—a forward-based contract in which two parties agree to swap streams of payments over a specified period of time.

.56 In effect, they exchange the investment performance of one underlying instrument for the investment performance of another instrument without exchanging the instruments themselves.

.57 There are different types of swaps, such as interest rate swaps and exchange rate swaps. An interest rate swap is when two parties agree to exchange interest payments on a set principal amount for a specified period of time. For example, when an entity pays interest under the swap at a variable rate and receives interest under the swap at a fixed rate, the entity actually pays or receives only the net amount under the swap. The most common form of interest rate swap entails the exchange of streams of fixed rate and variable interest payments. Other examples are basis swaps where both rates are variable but are tied to different index rates and fixed-rate currency swaps, whereby two counterparties exchange fixed-rate interest in one currency for fixed-rate interest in another currency.

.58 Interest rate swaps are often used because they allow the borrower to borrow in a readily accessible market yet obtain the type of debt they need via the swap. Swaps are also used to hedge existing debt obligations.

.59 If the dealership you are auditing is financing with swaps you should become familiar with what a swap is and how to audit such financial instruments.

Help Desk—The AICPA Audit and Accounting Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk) is helpful in explaining what swaps are and how to audit them.

.60 Keep in mind that Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, applies when accounting for swaps. When auditing swaps SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA Professional Standards, vol. 1, AU sec. 332) should be followed.

.61 The following are potential misstatements relating to swaps:

- Failure to identify the swap
- Failure to properly document the hedge and the expectation of hedge effectiveness
- Hedge not remaining highly effective on an ongoing basis, so that hedge accounting does not continue to be appropriate
- Assessment of hedge effectiveness inconsistent with the risk management strategy documented for the particular hedging relationship
- Dealership not assessing hedge effectiveness for similar hedging strategies in a similar manner, and not documenting such differences
- Incorrectly determining the fair value of the swap and the bonds
- Incorrectly computing and recording interest and accrued interest on the bonds
- Inadequate financial statement presentation and disclosure

.62 The following are inherent risks related to swaps:

- The transaction requires no initial cash outlay, and therefore detection of the derivative may be difficult.
- Management may not have a valuation model capable of valuing the interest rate swap and relies on the broker-dealer who arranged the transaction for the valuation of the swap.

- Credit risk related to the swap is moderate and is primarily related to the risk of nonperformance by the counterparty.

Finance and Insurance Income and SubPrime Lending

.63 Financing for high-credit risk customers, or *subprime lending*, continues to play a big role in a dealership's finance and insurance (F&I) area. Subprime loans are usually high-risk, high-yield loans offered to customers that would not qualify for traditional loans. Many financial institutions specialize in subprime loans. Because the majority of these loans are sold to a financial institution specializing in subprime loans, the dealership itself may have no exposure to risk of nonpayment. However, the auditor should closely review the terms of the arrangements between the dealer and the financial institution to ensure that such risk is indeed completely transferred. Many dealers as well as other financial institutions are getting out of the subprime lending area. In fact there has been much consolidation of subprime lenders and there have been many bankruptcies or foreclosures as well. 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. This past year has also seen an increase in the "buy here, pay here" business.

Buy Here, Pay Here

.64 Buy here, pay here, also referred to as a "note lot," is a type of used car business directed towards customers who purchase inexpensive, older model vehicles. The dealership usually provides its own financing. Customers typically provide a downpayment and finance the balance by a note to the dealership. These operations often involve high margins as well as high customer default rates and lack of effective collateralization. The notes generally carry stated interest rates in excess of current market rates, often as high as 30 percent. Accordingly, collection is often in doubt.

.65 Accounting Principles Board (APB) Opinion No. 10, *Omnibus Opinion*—1966, says that when "there are exceptional cases where receivables are collectible over an extended period of time and...there is no reasonable basis for estimating the degree of collectibility...either the installment method or the cost recovery method of accounting may be used."

- *Installment method.* The installment method defers the gross profit and treats each payment as if it included both recovery of cost and gross profit in the same ratio as the original sale. Thus if the original sale presumed a 60 percent gross profit, each principal payment would reduce the deferred gross profit by 60 percent of the amount received. Any receivables due more than one year from the balance sheet date should generally be classified as noncurrent.
- *Cost recovery method.* Under the cost recovery method revenue is credited and cost of sales debited for all receipts until costs are fully recovered. Only after receipts exceed the carrying value of the vehicle sold does the dealership recognize profits.

.66 Auditors may need to pay special attention to the collectibility of these receivables and whether they are realizable. Adequate allowances should be established. Also, management should comply with the guidance contained in APB No. 21, *Interest on Receivables and Payables*.

Financing at the Dealership

.67 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 may charge back a portion of the fee to the dealership.

.68 In determining when a dealership should recognize financing income, auditors should assess management's consideration of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial*

Assets and Extinguishments of Liabilities. Issued in September 2000, FASB Statement No. 140 provides accounting and reporting standards for transfers and servicing of financial assets and extinguishments of liabilities. FASB Statement No. 140 replaces FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, but carries over most of the FASB Statement No. 125 provisions without reconsideration.

.69 FASB Statement No. 140 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 interests 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:

- 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. (In other words, the contract is beyond the reach of the dealership and its creditors, even in bankruptcy.)
- b. Each transferee (or, if the transferee is a qualifying special-purpose entity [SPE], each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.
- c. The transferor does not maintain effective control over the transferred assets through either (a) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (b) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

.70 FASB Statement No. 140 requires that liabilities and derivatives incurred or obtained by transferors as part of a transfer of financial assets be initially measured at fair value, if practicable. It also requires that servicing assets and other retained interests in the transferred assets be measured by allocating the previous carrying amount between the assets sold, if any, and retained interests, if any, based on their relative fair values at the date of the transfer.

.71 FASB Statement No. 140 also requires:

- That servicing assets and liabilities be subsequently measured by (1) amortization in proportion to and over the period of estimated net servicing income or loss and (2) assessment for asset impairment or increased obligation based on their fair values.
- That a liability be derecognized if and only if either (1) the debtor pays the creditor and is relieved of its obligation for the liability or (2) the debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. Therefore, a liability is not considered extinguished by an in-substance defeasance.
- A debtor (1) to reclassify financial assets pledged as collateral and report those assets in its statement of financial position separately from other assets not so encumbered if the secured party has the right by contract or custom to sell or repledge the collateral and (2) to disclose assets pledged as collateral that have not been reclassified and separately reported in the statement of financial position.
- That a secured party disclose information about collateral that it has accepted and is permitted by contract or custom to sell or repledge. The required disclosure includes the fair value at the end of the period of that collateral, and of the portion of that collateral that it has sold or repledged, and information about the sources and uses of that collateral.
- An entity that has securitized financial assets to disclose information about accounting policies, volume, cash flows, key assumptions made in determining fair values of retained interests, and sensitivity of those fair values to changes in key assumptions.

- That entities that securitize assets disclose for the securitized assets and any other financial assets it manages together with them (1) the total principal amount outstanding, the portion that has been derecognized, and the portion that continues to be recognized in each category reported in the statement of financial position, at the end of the period; (2) delinquencies at the end of the period; and (3) credit losses during the period.

.72 This statement provides:

- Implementation guidance for assessing isolation of transferred assets, conditions that constrain a transferee, conditions for an entity to be a qualifying SPE, accounting for transfers of partial interests, measurement of retained interests, servicing of financial assets, securitizations, transfers of sales-type and direct-financing lease receivables, securities lending transactions, repurchase agreements including “dollar rolls,” “wash sales,” loan syndications and participations, risk participations in banker’s acceptances, factoring arrangements, transfers of receivables with recourse, and extinguishments of liabilities.
- Guidance about whether a transferor has retained effective control over assets transferred to qualifying SPEs through removal-of-accounts provisions, liquidation provisions, or other arrangements.

.73 The Audit Issues Task Force (AITF) 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 Financial Accounting Standards Board Statement No. 140” (AICPA, *Professional Publications*, vol. 1, AU sec. 9336.01-.21), 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. 140. 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 includes 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.

Leased Vehicles

.74 The leasing of vehicles has seen tough times over the past few years. The residual value that is set at the beginning of a lease is the most important factor when determining the profitability of a lease and the residual values on full-term leased vehicles have turned out to be much lower than originally anticipated. According to the Consumer Bankers Association, 68 percent of vehicles coming off lease in 2000 reached full term. Of those full-term vehicles returned, 95 percent resulted in losses to the lessor. This is up from 71 percent in 1998. The shortening of lease terms resulted in a record number of lease vehicles being returned in 1999 and 2000, flooding the used car market and driving down the residual values. Many independent companies have gotten out of the leasing industry, thereby reducing the number of leasing companies dealers have left to work with. In addition, the leasing companies that remain are promoting longer leases to help correct the oversupply of off-lease vehicles.

.75 In most cases when dealers lease a vehicle it 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.

Accounting for Leases

.76 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*, 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.

.77 First, at least one of the following four conditions must exist:¹⁷

- a. The lease transfers ownership of the vehicle to the customer by the end of the lease term.
- b. The lease contains a bargain purchase option.
- c. The lease term is equal to at least 75 percent of the vehicle's estimated economic life.
- d. 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.

.78 Second, the lease must fulfill both of the following criteria:

- a. Collectibility of the minimum lease payment is reasonably predictable.
- b. 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.

.79 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.

.80 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 Emerging Issues Task Force [EITF] Issue No. 98-9, *Accounting for Contingent Rent*, for guidance on how lessors and lessees should account for contingent rental income that is based on future specified targets.)

.81 Dealerships may also enter into operating leases. 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.¹⁸ 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.

.82 For operating leases, auditors should consider whether management has complied with the provisions and disclosures required by FASB Statement No. 13.

Customer Incentives

.83 Dealerships continue to offer special incentives to customers, such as free oil changes for a certain period of time. Auditors should inquire if their clients have offered any such incentives. Recently the EITF

¹⁷ 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.

¹⁸ 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.

has been discussing issues relating to certain sales incentives. The following EITF issues relate to the accounting for sales incentives and should be considered:

- EITF Issue No. 00-14, *Accounting for Certain Sales Incentives* (Consensuses were reached May 17–19, 2000, with revisions made to the EITF Abstracts at other various meetings.)
- EITF Issue No. 00-21, *Accounting for Multiple-Element Revenue Arrangements* (Originally discussed at the July 19–20, 2000, meeting, further discussion is planned, however any future discussions will not be applicable to SEC registrants.)
- EITF Issue No. 00-22, *Accounting for “Points” and Certain Other Time-Based or Volume-Based Sales Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future* (Originally discussed at the September 20–21, 2000, meeting. Consensuses were reached on Issue No. 3 at the January 17–18, 2001, meeting. Further discussion is planned at future meetings.)
- EITF Issue No. 00-25, *Vendor Income Statement Characterization from a Vendor to a Retailer* (Originally discussed September 20–21, 2000. Consensuses reached April 18–19, 2001.)

Help Desk—For more information about the EITF, see the AICPA *Audit Risk Alert*—2001/02 [AAM section 8010].

Employee Fraud

.84 Many dealers experience fraud at some time or another and much of this fraud is perpetrated by dealership employees. Some examples of dealership frauds include:

- Embezzlement by controller and other employees
- Unexplained shrinkage in parts and accessories
- Collusion (generally involving trade-ins and auction purchases when a salesperson, in exchange for payment, appraises a trade-in at a higher value or purchases a vehicle at auction at a higher value)

.85 With proper controls in place, many of these frauds can be deterred. Auditors should look for any of the following management controls which may mitigate the chance for such frauds:

- Owners review checks issued, including a timely review of bank statements.
- Check signing is limited to the dealer, general manager, and controller, and requires two signatures.
- Vehicle tags and keys are kept in a secured area.
- Strict records are maintained to track inventory.
- Locations are visited or certain tests are performed on a surprise or unannounced basis—for example, surprise vehicle inventory counts in the middle of the month.
- Employees are required to take vacation time at least once a year.
- There is a clear segregation of duties.
- Managers review write-offs, not just sign them.

.86 As discussed earlier in this Alert, SAS No. 82 provides guidance about an auditor’s responsibilities related to fraud.

Help Desk—For additional guidance on SAS No. 82, you may wish to refer to the AICPA Practice Aid *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* (product no. 008883kk), which includes issues likely to be encountered in applying SAS No. 82 to audits and valuable tools, such as sample documentation. The self-study

course *Consideration of Fraud in a Financial Statement Audit: The Auditor's Responsibilities under SAS No. 82* (product no. 732045kk) also provides additional guidance.

Independence

AICPA Independence Rule Modernization

.87 In light of fast-moving changes in society and business, the profession has responded by shifting from “firm-based” independence rules toward an approach that is “engagement team based.” In an effort to modernize the profession’s rules on independence, the Professional Ethics Executive Committee (PEEC) of the AICPA approved new independence rules on August 9, 2001. The rules become effective May 31, 2002. These significant revisions to section 101 of the AICPA Code of Professional Conduct seek to modernize and harmonize independence rules with other governing bodies, most notably the SEC, while simplifying the rules at the same time. For a more detailed discussion of these rules see the *AICPA Audit Risk Alert—2001/02* [AAM section 8010].

Help Desk—Final rules are available at www.aicpa.org/members/div/ethics/adopt.htm and published in the November 2001 issue of AICPA’s *Journal of Accountancy*.

Regulatory Issues

.88 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 dealership industry. For example, under California’s clean air rules, a certain percentage of cars sold in the state must emit no harmful exhaust. Car manufacturers continue to research alternative methods to power vehicles without emitting harmful exhaust. Hybrid vehicles are becoming more prevalent. According to *AutoExec* magazine, sales of the Honda Insight and the Toyota Prius have more than doubled. State and local regulations generally fall into four categories: (1) environmental, (2) taxation, (3) vehicle registration, and (4) business practices.

Current Legislation

- .89 The following may be of interest to dealers. You may want to keep abreast of the status of these issues.
- The corporate average fuel economy standards (CAFE)
 - Voluntary Arbitration Bill¹⁹

Tax Issues

.90 Again, things have been fairly quiet this past year relating to tax issues for dealerships. The NADA reported that the IRS plans to address the issue of “demos” sometime this year; therefore we will discuss demos again in this year’s Alert. This section also discusses other areas that continue to be important to dealerships. In auditing the financial statements of auto dealerships, in particular when evaluating management’s accounting for income taxes in accordance with FASB Statement No. 109, *Accounting for Income Taxes*, as amended, auditors should be familiar with federal, state, and local tax rules.

Help Desk—Visit the IRS Web site for information on tax laws and regulations specific to the automotive industry at www.irs.gov/prod/smallbiz/automotive/rules_regulations.htm.

¹⁹ This bill, introduced in the Senate, would prevent manufacturers from forcing arbitration on dealers and is identical to the measure passed last year by the House.

New Tax Laws and Regulations

Federal Trade Commission's New Privacy Regulations

.91 Effective July 1, 2001, the Federal Trade Commission (FTC) rule requires any business collecting financial information from customers to notify the customer of the business's privacy policies. The NADA Web site provides guidance for dealerships on this regulation at www.nada.org/memberservices/governmentaffairs/regulation. You must be a member of NADA to obtain this information. See the AICPA *Audit Risk Alert*—2001/02 [AAM section 8010] for more information about the new privacy regulations.

Revenue Procedure 2001-23

.92 Revenue Procedure 2001-23 provides an alternative LIFO (last in, first out) inventory computation method (the used vehicle alternative LIFO method) for used vehicle dealers. Used vehicle dealers may change to or adopt this alternative method. Used vehicle dealers may obtain automatic consent to change their method of accounting to this alternative method by following the procedures in Revenue Procedure 99-49, 1999-52 C.B. 725 (or its successor) as modified by this Revenue Procedure.

Help Desk—To obtain a copy of Revenue Procedure 2001-23 visit www.revenueprocedures.com/procedures/2001/revproc2001-23.htm.

Parts Inventory

.93 Last year, the U.S. Tax Court ruled that the use of replacement cost to value parts is contrary to LIFO regulations, and the IRS added the entire parts LIFO reserve back into the dealer's income. The Tax Court ruled that parts should be valued at actual cost rather than replacement cost.²⁰ In response to this, the NADA proposed four alternatives to the IRS for ways dealers using LIFO should value parts inventory. The NADA proposed that dealers may:

- a. Value inventory based on actual cost of most recent purchases
- b. Adjust year-end value based on number of turns for the year
- c. Use automakers' midyear prices to price current inventory
- d. Price year-end inventory against pricing at the beginning of the year

.94 This case is currently on appeal.

.95 Some dealerships using LIFO may value their parts and accessories inventories at replacement cost. Because this method is a departure from 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.

LIFO Conformity Rules

.96 LIFO continues to be a focus of concern for the IRS. Franchised automobile dealers are normally required to issue monthly income statements to their franchisor, who is also typically a creditor of the dealership.

²⁰ Mountain State Ford Truck Sales, Inc. vs. Comm. (docket no. 16350-95) can be obtained from the Tax Court Web site, www.taxcourt.gov

These monthly statements are often prepared in a format required by the franchisor or on a preprinted form supplied by the franchisor. The 12th-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 13th-month statement.

.97 For several years, there was uncertainty about whether certain monthly income statements issued to the franchisor or creditor violated the LIFO conformity requirement of IRC section 472(c) or (e)(2). In 1997, the 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 (Revenue Procedure 97-44).

.98 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 12th-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 12th-month income statement issued to the credit subsidiary of its franchisor uses the LIFO inventory method to determine net income for both the 12th-month and for the entire year (even if the LIFO adjustment is only a reasonable estimate). The LIFO adjustment can be made either 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.

.99 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, as an initial installment of one-third of the total, followed by two other equal payments on January 31, 1999, and January 31, 2000. Failure to make any of these installment payments in a timely manner would void the relief protection.

.100 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 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.

.101 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 to shareholders and creditors.

.102 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 that, in most cases, will be substantial.

.103 IRS rulings and procedures that apply include the following:

- IRS Revenue Procedure 97-36, which supersedes IRS Revenue Procedure 92-79 and is effective 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 Revenue Procedure 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*.

The Use of Demonstrators

.104 The NADA reported that under the IRS's new Industry Issue Resolution Pilot Program dealership demos is one of seven subjects picked by the IRS to be considered. The pilot program was created to resolve frequently disputed tax issues that affect large numbers of businesses.

.105 Demonstrator inventory comprises the value of new vehicles placed in demonstrator service. Generally these autos are taken out of the new inventory accounts. Any labor and material costs for dealer-installed equipment and accessories are added to the inventory value; the cost of any such equipment or accessories removed from the vehicle is subtracted from inventory. Many dealerships limit the number of miles that demonstrators may be driven. Demonstrators are generally not written down for wear and tear or depreciation because, even after use, their market values generally exceed inventory cost. If cost exceeds value, however, a write-down may be necessary. When a demonstrator is sold, it is transferred back to new vehicle inventory because the sale is reported as a new vehicle sale.

.106 If the IRS determines that a dealership violated the special rules that govern qualified automobile demonstration use, the value of the use of employer-provided vehicles is a fringe benefit that must be included in the employee's gross income, and the dealer will need to pay the related employment taxes. IRS Private Letter Ruling 9801002 discusses situations in which the IRS found a dealership to be in violation of the special rules for "certain fringe benefits." The private letter ruling says that qualified automobile demonstration use should be treated as a working condition fringe. (Section 132(a)(3) specifically provides that qualified automobile demonstration use should be treated as a working condition fringe.)

.107 *Qualified automobile demonstration use* is defined as any use of an automobile by a full-time automobile salesperson in the sales area in which the automobile dealer's sales office is located if:

- a. Such use is provided primarily to facilitate the salesperson's performance of services for the employer.
- b. There are substantial restrictions on the personal use of the automobile by the salesperson.

.108 The substantial restrictions on the personal use of the automobile by the salesperson exist when all of the following conditions are met:

- a. Use by individuals other than the full-time automobile salesperson is prohibited.
- b. Use for personal vacation trips is prohibited.
- c. The storage of personal possessions in the automobile is prohibited.
- d. The total use of the automobile, by mileage, by the salesperson outside the salesperson's normal working hours is limited.

.109 The IRS will typically examine the records of demonstrator vehicles to substantiate that only qualified personnel have been assigned demonstrators and that personal use is accounted for properly. Lists of personnel-assigned demonstrator vehicles may be checked against payroll records to detect family members and others who do not qualify for demonstrator vehicles. Individuals not qualifying for demonstrator vehicles would have to report additional income attributable to their personal use of a company vehicle. Depreciation expense accounts are reconciled to verify that depreciation is not taken on demonstrator vehicles.

.110 You may want to familiarize yourself with Private Letter Ruling 9801002 to see where the IRS found the dealership to be in violation and compare that with the practices of your clients. In addition, be alert to any decision made by the IRS through the Industry Issue Resolution Pilot Program.

New Auditing and Attestation Pronouncements

.111 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. The AICPA *Audit Risk Alert*—2001/02 [AAM section 8010] contains a summary explanation for all these issuances.

Help Desk—For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 94	<i>The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit</i>
SOP 01-3	<i>Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law</i>
Audit Guide	<i>Auditing Derivative Instruments, Hedging Activities, and Investments in Securities</i>
Audit Guide	<i>Auditing Revenue in Certain Industries</i>
Audit Guide	<i>Audit Sampling</i>
Audit Guide	<i>Analytical Procedures</i>
Practice Alert 01-1	<i>Common Peer Review Recommendations</i>

Accounting Pronouncements and Guidance Update

.112 Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's alert. The AICPA *Audit Risk Alert*—2001/02 [AAM section 8010] contains a summary explanation of all of these issuances.

Help Desk—For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 141	<i>Business Combinations</i>
FASB Statement No. 142	<i>Goodwill and Other Intangible Assets</i>
FASB Statement No. 143	<i>Accounting for Asset Retirement Obligations</i>
FASB Statement No. 144	<i>Accounting for the Impairment or Disposal of Long-Lived Assets</i>
FASB Technical Bulletin No. 01-1	<i>Effective Date for Certain Financial Institutions of Certain Provisions of Statement 140 Related to the Isolation of Transferred Financial Assets</i>
SOP 00-3	<i>Accounting by Insurance Enterprises for Demutualizations and Formations of Mutual Insurance Holding Companies and for Certain Long-Duration Participating Contracts</i>
SOP 01-1	<i>Amendment to Scope of Statement of Position 95-2, Financial Reporting by Nonpublic Investment Partnerships, to Include Commodity Pools</i>
SOP 01-2	<i>Accounting and Reporting by Health and Welfare Benefit Plans</i>
AICPA Audit and Accounting Guide	<i>Audits of Investment Companies (With Conforming Changes as of May 1, 2001)</i>
Questions and Answers	<i>FASB Statement No. 140</i>

On the Horizon

.113 Auditors should keep abreast of auditing and accounting developments and related guidance that may affect their engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS. The AICPA *Audit Risk Alert*—2001/02 [AAM section 8010] summarizes some of the more significant exposure drafts outstanding.

.114 The following table lists the various standard-setting bodies' Web sites where you can go to obtain information on outstanding exposure drafts and download a copy of the exposure draft.

<i>Standard Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA's standard-setting committees are now publishing exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process the submissions more efficiently. Include your full name, mailing address, and, if known, your membership and subscriber number in the message.

New Framework for the Audit Process

.115 The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB expects to issue a series of exposure drafts in late 2001 and 2002. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

.116 Some of the more important changes to the standards that are expected to be proposed are:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Among other things, this will improve the auditor's assessment of inherent risk and eliminate the "default" to assess inherent risk at the maximum.
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes a sufficient knowledge of controls to plan the audit.
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.
- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures.

.117 These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

.118 You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Resource Central

Educational courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

.119 The following are some of the AICPA publications that deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* Audit Guide (product no. 012520kk)
- *Auditing Revenue in Certain Industries* Audit Guide (product no. 012510kk)
- *Audit Sampling* Audit Guide (product no. 012530kk)
- *Analytical Procedures* Audit Guide (product no. 012551kk)
- *Accounting Trends & Techniques—2001* (product no. 009893kk)
- *E-Business Industry Developments 2001/02* Audit Risk Alert [AAM section 8210]
- *Auditing Estimates and Other Soft Accounting Information* Practice Aid (product no. 010010kk)
- *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* Practice Aid (product no. 006701kk)
- *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82* Practice Aid (product no. 008883kk)

Audit and Accounting Manual

.120 The *Audit and Accounting Manual* is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs, auditors' reports, checklists, engagement letters, management representation letters, and confirmation letters.

CD-ROM

.121 The AICPA is currently offering a CD-ROM product titled *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 that includes all Guides and the related Audit 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.

Educational Courses

.122 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the automobile dealership industry. Those courses include:

- *Automobile Dealership Accounting* (product no. 735156kk)

Online CPE

.123 The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee (\$95 for members and \$295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

CPE CD-ROM

.124 *The Practitioner's Update* (product no. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

.125 To order AICPA products, receive information about AICPA activities, and find help on your membership questions call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.126 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.127 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.

Conferences

National Auto Dealership Conference

.128 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.

Web Sites

AICPA Online

.129 AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, AICPA Online offers information about AICPA products and services, career resources, and online publications.

CPA2Biz

.130 This new Web entity is the product of an independently incorporated joint venture between the AICPA and state societies. It currently offers a broad array of traditional and new products, services, communities, and capabilities so CPAs can better serve their clients and employers. Because it functions as a gateway to various professional and commercial online resources, cpa2biz.com is considered a Web "portal."

.131 Some features cpa2biz provides or will provide include:

- Online access to AICPA products such as Audit and Accounting Guides, and Audit Risk Alerts
- News feeds each user can customize
- CPA “communities”
- Online CPE
- Web site development and hosting
- Electronic procurement tools to buy goods and services online
- Electronic recruitment tools to attract potential employees online
- Links to a wider variety of professional literature
- Advanced professional research tools

Other Helpful Web Sites

.132 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of this Alert.

.133 This Audit Risk Alert replaces *Auto Dealership Industry Developments—2000/01*.

.134 The Audit Risk Alert *Auto Dealership 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 e-mail your comments to ldelahanty@aicpa.org or write to:

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Appendix

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 bank and nonbank 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 criminal and civil penalties. Automobile dealerships are defined as financial institutions under the Act (Title 31 USC 5312(a)(5312(a)(2)(T)) but are not currently subject to BSA rules. IRS regulations require dealerships to file reports for cash (and certain cash equivalents) transactions greater than \$10,000 (26 USC 6050I). Cash transactions conducted by or on behalf of the same customer in a 24-hour period must be aggregated and, if the cash transactions exceed \$10,000, must be reported. In addition, multiple cash transactions conducted over the course of a rolling one-year period, by or on behalf of the same person, must also be aggregated and reported if the dealership knows or has reason to know that the transactions are related.

As with the BSA, structuring transactions to avoid reporting is prohibited, and willful failure to file a Form 8300 or to file incorrectly may result in severe criminal and civil penalties.

BSA rules governing the reporting of international transportation of currency or monetary instruments (CMIRs—Customs Form 4790) have not been modified since 1989, and foreign bank and financial accounts (FBARs—Treasury Form TDF 90-22.1) have not been modified since 1987. However, on January 16, 1997 (see the *Federal Register*), the Treasury issued a proposal to expand the statutory definition of monetary instruments to include foreign bank drafts.

For copies of BSA forms mentioned in this appendix and more information regarding anti-money laundering issues, consult the FinCEN Web site at www.treas.gov/fincen.

.136

Sources of Information

Organization	General Information	Fax Services	Internet Addresses
American Institute of Certified Public Accountants	<i>Order Department (Member Satisfaction)</i> Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (888) 777-7077	<i>24 Hour Fax Hotline</i> (201) 938-3787	www.aicpa.org
Financial Accounting Standards Board	<i>Order Department</i> P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org
National Automobile Dealers Association²¹	8400 Westpark Drive McLean, VA 22102 (703) 821-7000		www.nada.org
American International Auto Dealers Association²²	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 8801.]

²¹ The NADA 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.

²² The American International Auto Dealers Association is an organization promoting the interests of foreign franchises.

AAM Section 8210

E-Business Industry Developments—2002/03

How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your e-business audits. The knowledge delivered by this Alert assists you in achieving a more robust understanding of the business environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the world of e-business activities, and if you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining knowledge of e-business issues and understanding them.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

E-Business Background

.04 A critical component of a successful e-business audit is a comprehensive knowledge of the environment in which e-business operates. The e-business environment is almost borderless—and, because of the relative infancy of this environment, established standard guidelines and metrics for performance may not be as robust as in other areas. For these reasons, among others, you should carefully consider the unique audit implications of dealing with or being in such a new and vaguely defined industry. For example, the e-business environment contains unique business risks resulting from the reliance on technology. These risks can include lack of paper audit trails, extensive use of information technology, risks/exposure of loss of data, and system interdependencies, among others.

.05 The primary purpose of this Alert is to address the most important current auditing, accounting, and regulatory issues related to e-business to help you as you plan your engagements. See the later sections of this Alert that relate directly to these topics.

Internet and E-Business Development

.06 The Internet occupies a large presence today in our everyday lives and business lives. Among the many things that Internet technologies allow is providing the opportunity for using e-business to:

- Increase brand awareness and expand sales opportunities (by opening additional sales channels, for example)
- Improve communications and customer service (by providing product descriptions, facilitating order placement and tracking order status, for example)
- Enhance purchasing and selling functions (by linking systems to sales and inventory databases to allow for production of automatic purchase orders, for example)
- Create more efficient, convenient, and customized customer transactions (for example, allowing larger items for selection at the tip of the customer's typing fingers)

.07 These business functions, and the use of the Internet to conduct business, improve and expand the horizon for conducting business in a convenient, efficient, and timely manner. However, these somewhat rosy descriptors about conducting e-business are somewhat offset by the tradeoff of risk necessary to obtain them. Consider, for example, the daily reminders of the risk associated with various security vulnerabilities, “denial of service” attacks, and other threats to revenues and assets. In addition, special e-business risks can stem from an enterprise’s information technology (IT) infrastructure, either through inherent vulnerabilities or through internal or external attacks. Further, vulnerabilities in IT infrastructure can create exposure to other e-business risks, such as those associated with compromised privacy, falsified authenticity, destructive programs, and issues surrounding the availability and integrity of data. System interdependencies can sometimes make an e-business enterprise vulnerable through the system of a business partner, even if the enterprise itself effectively manages the risk within its own boundaries. You can find a more detailed discussion of e-business risk later in this Alert in Appendix A, “Identifying and Managing E-Business Risks.”

E-Business Models

.08 The variety of e-business models is limited only by entrepreneurial vision. Companies are constantly innovating to compete in the marketplace. Many e-business models encompass business-to-consumer (B2C) transactions, business-to-business (B2B) transactions, and variations on these themes, as noted in the following chart. Several new models have emerged, as well. (Note the acronyms in the following chart as they relate to government, business, consumer, and employee.)

	<i>Government (G)</i>	<i>Business (B)</i>	<i>Consumer (C)</i>	<i>Employee (E)</i>
Government	G2G	G2B	G2C	G2E
Business	B2G	B2B	B2C	B2E
Consumer	C2G	C2B	C2C	—

.09 The key models can be described as follows:

- B2C—Typically a retailer selling directly to the consumer; until recently, this is the sector that has shown the fastest growth. Lately, however, B2B has shown the most growth potential, and the B2C growth rate now appears to be decelerating. (See the following section for additional information on B2Cs.)
- B2B—Typically a business selling up, down, or across the supply chain, involving business partners or business consortia. (See the subsequent section of this alert for additional information on B2Bs.)
- B2E—Typically a system enabling intercompany (intragroup) e-mails over the Internet to be directed to the correct department.
- B2G—A system that allows for electronic submission of business information to governmental entities, for example, the filing of corporate tax returns.
- C2G—A system that allows for electronic submission of individual information to governmental entities, for example, the filing of income tax returns.

The Differences Between B2C and B2B E-Commerce

.10 The participants of B2C and B2B e-commerce differ. B2B users are other companies, whereas B2C users are individuals. Overall, B2B transactions are more complex and have higher security needs. And, in general, B2B involves processing large transaction volumes and potentially large dollar amounts.

.11 Beyond that, there are other major distinctions:

- *Negotiation* is selling to another business and involves haggling over prices, delivery, and product specifications. This is not the case with most consumer sales because, for example, it is easier for retailers to place a catalog online and also explains why the first B2B applications were for buying finished goods or commodities that are simple to describe and price.

- *Integration* involves a situation in which retailers conducting B2C transactions don't have to integrate with their customers' systems. Companies selling to other businesses, however, need to make sure they can communicate without human intervention.

Business-to-Consumer Models

.12 Although the term *e-commerce* generally refers to the value of goods and services sold online, B2C applies to any business or organization that sells its products or services over the Internet to consumers for their own use. A good example of B2C e-commerce is Amazon.com, the online bookseller that launched its site in 1995 and quickly took on the nation's major retailers. However, in addition to online retailers, B2C has grown to include the online sale/provision of services such as online banking, travel services, online auctions, health information, and real estate sites.

.13 *Some of the Major Challenges of B2C E-Commerce.* When it comes to determining what B2C presents as challenges, you can think about:

- *Getting consumers to buy things*—An e-commerce site cannot live on traffic alone. Getting visitors to the site is only half the battle. Whether they buy something is what determines if the business wins. The so-called conversion rate (converting visitors into purchasers) for B2C e-commerce sites is still fairly low. Some ways to boost conversion rate include improving navigation, simplifying checkout process (such as one-step checkout and easily replaced passwords), and sending out e-mails with special offers.
- *Building customer loyalty*—With so many sites out there, how can companies build a strong relationship with customers? Here are a couple of suggestions:
 - Focus on personalization. A wide array of software packages is available to help e-commerce sites create unique boutiques that target specific customers. For example, American Airlines has personalized its Web site so business fliers view it as a business airline and leisure travelers see it as a vacation site. Amazon, which built its own personalization and customer relationship management (CRM) systems, is well known for its ability to recognize customers' individual preferences.
 - Create "stickiness." Stickiness of a Web site refers to the site's ability to keep visitors engaged for long periods and to keep them coming back. Examples of sticky Web sites include www.Yahoo.com, www.AOL.com, and www.eBay.com. One solution to the challenge of creating stickiness is to keep content fresh and frequently update offerings.
 - Create an easy-to-use customer service application. Providing just an e-mail address can be frustrating to customers with questions. Live chat or, at the very least, a phone number contact to help resolve questions can help.
- *Providing order fulfillment*—E-commerce has increased the focus on customer satisfaction and delivery fulfillment. One cautionary tale is the Toys "R" Us holiday debacle in 1999, when fulfillment problems caused some Christmas orders to be delivered late. Since then, companies have spent billions of dollars trying to improve their logistical systems, to guarantee on-time delivery. Providing instant gratification for customers still isn't easy, but successful B2C e-commerce operations are finding that fulfillment headaches can be eased with increased focus and investment in supply chain and logistical technologies.

.14 *Importance of Channel Conflict to E-Business.* Channel conflict, or disintermediation, occurs when a manufacturer or service provider bypasses a reseller or salesperson and starts selling directly to the customer. Some sectors, including the PC and automobile industries, are particularly vulnerable to entities that engage in disintermediation, as are service industries such as insurance and travel. Levi's, for example, pulled its Web site after its resellers protested. Now, some entities that struggled with channel conflict are now finding ways to approach e-commerce without upsetting their salespeople. For example, big car companies and manufacturers, such as Maytag, are setting up Web sites that allow customers to decide what they want before being redirected to a local dealer.

.15 Major B2C Models. As noted in last year's Alert, the short lifetime of the digital economy has witnessed evolution of the following four major categories of B2C models:

- Online stores, marketplaces, and services (Dell, amazon.com, eBay, and Charles Schwab)
- Content providers (the *Wall Street Journal* and *Consumer Reports*)
- Content aggregators and portals (Yahoo)
- Infrastructure providers (Sprint, Cisco Systems, Lucent, and BroadVision)

Within each of these categories, there are many different business models that include an enormous amount of hybridization and innovation. There is also cross-pollination between B2C and B2B variations of these models because what works for B2C also can apply to B2B.

Business-to-Business Models

.16 The term *B2B* is used generically, to describe all online marketplaces where buyers and sellers congregate to exchange goods and services for money. It is important to note that B2B can be organized either horizontally or vertically.

- *Horizontal markets* cut across many industries, typically providing a common service, such as financial services; benefits management; and maintenance, repair, and operating (MRO) equipment procurement process management. Popular examples are Ariba Network and Commerce One's MarketSite.net.
- *Vertical markets* concentrate on one specific industry, such as agriculture and chemicals, and seek to provide all the services needed by that industry. Popular examples are VerticalNet, Chemconnect, and Covisint.

.17 There are three common models currently in use:

- *Buy-centric markets* are the exact opposite of sell-centric markets. In these markets, a few big buyers join forces to build a marketplace where small fragmented sellers can sell their goods. This is great for buyers because it permits quick and easy price comparison-shopping. Popular examples are K-Mart's Retail Link, FreeMarkets.com, and Covisint.
- *Sell-centric markets* are markets in which one or a few big sellers work together to build a marketplace for many small fragmented buyers. Typically revenues are derived from ads, commissions on sales, or fees for delivering qualified leads to suppliers. Popular examples are Grainger.com, GE Global Exchange, DoveBid, GoFish.com, GlobalFoodExchange.com, E2Open.com, and TradeOut.com.
- *Neutral exchanges* appear where both the sellers and buyers are fragmented. In this environment, a third party creates a neutral exchange and performs the transactions through a bid/ask system. The middleman, or "net market maker," here cause "disintermediation," for which they receive a cut or transaction fee for each deal. The most important success factor for these exchanges is to reach "liquidity" or critical mass of both number and size of the transactions running through the exchange. Popular examples are NASDAQ, Altra, Paper Exchange, and Arbinet.

.18 Some more specific examples of several B2B models are presented below.

- *Public exchanges (also called marketplaces).* A public vertical B2B electronic marketplace is a Web site run by a third party centered around a commodity or service that is open to many buyers and sellers. At a vertical B2B Web site, an e-business purchasing function may provide a link to its own purchasing Web site or post the specifications for its purchasing requirements. Not only does this type of arrangement provide the opportunity for great cost savings and efficiency in the electronic marketplace, but the public exchange also allows purchasers and sellers to obtain the best price quotes in minutes instead of days.

Auditors of e-businesses that participate in a vertical B2B electronic marketplace should remember that some of the source records for purchasing transactions may exist on computer systems outside of the control of the audit client. If so, it is necessary to be familiar with Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324.24–.56), and with the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*. See the “Reports From Service Organizations” section later in this Alert for further discussion of SAS No. 70 issues.

- *Industry portals.* An industry portal is very similar to a vertical B2B electronic marketplace except that a portal may include many more links to information and services common to any business in that industry. Such links might provide general news, sports, financial services, and other non-industry-specific services.

An e-business may conduct the purchasing function on an industry portal in the same manner as for a vertical B2B electronic marketplace. Consider, for example, the industry portal www.cpa2biz.com, which offers many things a CPA might need, from the latest authoritative publications to conference registration, CPE products, and state society news and announcements.

- *Supply-chain extranets.* An extranet is a Web site that an e-business sets up for its prospective and current trading partners. The site is accessible to registered users, with a user ID (identification) and password. The extranet site provides information about the products and services the company is interested in purchasing as well as specification requirements. Information about the company’s current inventories is linked to its internal databases and also may be available to certain customers. Access to the site usually requires establishing a preexisting relationship between the trading partners. Ford’s AutoXchange and GM’s TradeXchange are extranets designed not only to link Ford and GM with suppliers, but also to link suppliers with each other.

The audit implication for a client that operates its own extranet for purchasing is that the supplier may control elements of the electronic purchasing function, and the auditor will have to gain an understanding of the internal controls over these functions at the supplier. For further discussion of internal control issues, see the “Internal Control as It Affects Audit Evidential Matter” section later in this Alert.

- *Virtual private networks or private trading networks.* Some e-businesses may establish virtual private networks (VPNs) with trading partners. A VPN is a logical network that provides user privacy over a public network, such as a frame relay or, especially, the Internet, using tools such as encryption in various combinations. When used in the purchasing function, VPNs are a good means to ensure the secure transmission of data.

From an audit standpoint, VPNs offer strong controls over the purchasing function. These networks offer transactions logging and authenticating trading partners, as well as the integrity of information, the identification of suppliers, and the nonrepudiation of transactions using digital signatures. See more on the issue of digital signatures later in this Alert in the “Recent Regulatory Developments” section.

E-Business Economic Environment

The U.S. Business Environment

.19 As of late in the third quarter of 2002, anxious economists are downgrading their forecasts, and some crucial sectors of the economy are pushing the likelihood of a rebound into next year because of the abrupt slowdown in the economic recovery. For now, the overall economy is expanding, but sluggishly. Jobs are growing, but barely. And with a depressed stock market and reactions to further fears of terrorist strikes weighing on the national psyche, there is none of the exuberance that marked the recovery in the late 1990s.

.20 The economy appears to be in a struggle between declining business confidence and strong consumer spending. Eventually, consumer demand should overcome business wariness unless cautious businesses cut so many jobs that consumers finally give up. The same dynamic was at work during the fall of 2001. After September 11th of that year, the business sector froze, but the consumer sector did not, and eventually consumer demand jump-started the economy.

.21 The underlying economic fundamentals¹ in our economy remain relatively sound and point toward a moderate economic growth scenario. However, stock market weakness, coupled with recent data releases, has prompted downward forecast revisions.

The Sarbanes-Oxley Act

.22 On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the Act). The Act includes far-reaching changes in federal securities regulation that could represent the most significant overhaul since the enactment of the Securities Exchange Act of 1934. The Act creates the Public Company Accounting Oversight Board (PCAOB) to oversee the audit of public companies that are subject to the securities laws of the Securities and Exchange Commission (SEC). In addition, the Act prescribes a new set of auditor independence rules, new disclosure requirements applicable to public companies and insiders, and harsh civil and criminal penalties for persons responsible for accounting or reporting violations. The Act also imposes new restrictions on loans and stock transactions involving corporate insiders.

.23 A more complete summary of the Act is available on the AICPA Web site at www.aicpa.org/info/sarbanes_oxley_summary.htm.

General E-Business Trends

.24 Although numerous market research firms have tracked and reported information about e-business sales for several years, the U.S. government began officially reporting such information only in late 1999. For the year 2001 (totals reported in this section are the most recent available as of the printing of this Alert), the U.S. Department of Commerce reported total e-commerce sales of \$35.9 billion.² For the second quarter of 2002, the Department of Commerce reported total e-commerce sales of \$10.2 billion (compared to \$8.2 billion for second quarter 2001), a 24.2 percent increase in sales over the prior year's quarter.

.25 Although the Department of Commerce does not separately track B2C and B2B, it estimates that more than 90 percent of e-commerce is concentrated in the B2B area. A number of market forecasters are predicting even bigger things down the road for B2B companies. However, their estimates vary widely depending on what they measure and how they measure it. According to IDC (a Boston-based market research firm), worldwide B2B e-business will generate \$2.6 trillion in revenues by 2004. On the other hand, Gartner, Inc., a Stamford, Connecticut, research firm, forecasts that the worldwide B2B market should total \$1.9 trillion in 2002 and \$8.5 trillion by 2005. Not to be left out, small businesses (those with fewer than 100 employees) are also jumping on the B2B bandwagon. Although only 850,000 small businesses were engaged in B2B transactions in 1999, a U.S. Small Business Administration survey projects that this figure will leap to 2.9 million by 2003.

.26 On the B2C side, despite a disastrous couple of years recently for many dot-com merchants, online retail sales grew 21 percent, to \$51.3 billion in 2001, according to a study conducted by the Boston Consulting Group. Predictions indicate further profitability and growth for 2002 due to continued growth in consumer spending online and additional cost efficiencies, with an anticipated increase of 41 percent in consumer spending online.

¹ Underlying economic fundamentals determine the long-term trend around which the business cycle weaves. The dips stem from temporary deficiencies of investment, consumption, net exports, and government spending. The task of stabilization is to minimize the swings over and under the sustainable trend of gross domestic product growth.

² The Department of Commerce limits the definition of *e-commerce* to the value of goods and services sold online.

.27 Online penetration by product category also grew. Out of 15 categories studied, sales in seven, including computer hardware and software, books, music and videos, toys, and consumer electronics, represented more than 5 percent of all retail sales for those respective categories, with penetration in some categories as high as 17 percent.

.28 The Boston Consulting Group predicted that 2002 would be the beginning of a profitable era in online retailing. It was anticipated that retailers not only would continue to improve marketing effectiveness, but they also would have opportunities to realize efficiencies in the supply chain and product fulfillment.

.29 Online holiday sales in 2002 are projected to total \$38.2 billion worldwide, a 48 percent increase from the same period last year, according to Gartner, Inc. Also, according to Gartner, Inc., Europeans will spend more money online this holiday season than any other region, with revenue reaching \$15.77 billion. North America will fall to second place with revenue at \$15.66 billion.

.30 Electronic commerce is a small part of total retail sales, so e-commerce growth depends less on retail ups and downs and more on the experience of Internet users and the maturity of Internet retailers, according to Gartner, Inc.

Where Are We Headed?

.31 We have now lived through so many iterations of e-business that it's hard to keep track of its rapid development. For example, several years ago, the hottest topic of discussion was business-to-consumer e-commerce applications, which were going to radically alter the way we shopped for everything. Since then, the scales have tipped in the direction of both dollar and transaction volumes from the B2C to the B2B models.

.32 The B2B model became the rage with such companies as Ariba and Extensity, which facilitated the ability to do business electronically. This minor subset of the entire business-to-business equation soon gave rise to the notion of electronic exchanges. These exchanges for vertical markets promised to reinvent how companies transact business by letting them essentially bid in real time for business among an established set of buyers and suppliers. With companies such as Oracle, CommerceOne, and Ariba leading the charge, these types of exchanges popped up in every major industry segment.

.33 According to some experts, the next wave of e-business will be driven by business-to-business-to-consumer systems. Otherwise known as b-to-b-to-c, these systems will emerge because business models in the digital economy will not tolerate inefficiencies.

Recent Regulatory Developments

Internet Tax Issues

.34 State and local governments are concerned about losing sales and use tax revenue because of untaxed Internet sales. A recent estimate of the amount of sales tax revenue lost in 2002 because of the nontaxation of Internet sales puts the amount at more than \$10 billion.

.35 On November 28, 2002, President Bush signed a bill to extend the Internet Tax Freedom Act (ITFA) until November 1, 2003. This no-frills extension keeps Internet access free of sales tax in most states and puts off for two years any further action by Congress on Internet taxation. The extension was passed in spite of the objection of some in Congress, who wanted a commitment to give states the power to enforce sales tax collection, if the states simplify sales tax compliance.

.36 The bill is the culmination of a long debate in both houses of Congress on the role of the federal government in state sales tax. At different times during the debate, those opposed to taxing e-commerce

floated proposals to make the ITFA permanent, or to ban sales tax on digital products. Those supporting the states pushed for a commitment on the part of Congress to grant states the power to enforce sales tax collection, if the states simplify sales tax compliance (see the following section on state sales tax simplification).

.37 Internet Tax Freedom Act Basics. The ITFA exempts Internet access services from state and local taxes, such as sales tax. In addition to Internet access, this ban extends to many Internet-based services. However, the ban on taxation of Internet access is not complete. The eight states that currently tax Internet access can continue to do so. The ITFA also prohibits multiple and discriminatory taxation of electronic commerce. However, the ITFA does not directly affect sales of tangible products over the Internet.

.38 Not all Internet access is protected by the ITFA. In addition to allowing tax in states that already tax Internet access, the ITFA allows tax on Internet providers that engage in certain kinds of activities. These activities include knowingly providing access to materials that are harmful to minors, unless access to those materials is restricted. This exception does not apply to Internet access providers, to the extent they are providing Internet access. Presumably, an Internet service provider (ISP) engaged in providing Internet access, and engaged in the business of providing unrestricted access to materials harmful to minors, would be partly taxable.

.39 The ITFA prohibits discriminatory taxes on e-commerce. Discriminatory taxes include taxes imposed on e-commerce that are not generally imposed on transactions accomplished by other means. For example, a state could not impose a tax on access to an online newspaper, when newspaper sales from a street corner are tax free.

.40 In addition, discriminatory taxes include taxes imposed at a different rate on e-commerce than on the same transactions accomplished by other means. For example, a state could not impose a 7 percent sales tax on sales of flowers via the Internet, when it imposes a 5 percent tax on sales from a local flower shop.

.41 The ITFA includes provisions relating to the ability of a state to require a remote seller to collect sales and use tax. One provision relates to the effect of access to a Web site on a vendor's liability to collect sales tax. According to the ITFA, states may not require a vendor to collect a tax if "the sole ability to access a site on a remote seller's out-of-state computer server is considered a factor in determining a remote seller's tax collection obligation."

.42 The ITFA prevents states from imposing an obligation to collect or pay tax on a different person than in the case of non-Internet transactions involving similar goods and services.

.43 State Sales Tax Simplification. States are attempting to address the issue of sales tax simplification. The District of Columbia, 45 states, and thousands of local governments impose sales taxes. To cope with complaints about disparities among the jurisdictions, the National Governors Association created the Streamlined Sales Tax Project (SSTP). The SSTP, comprising tax administrators from 30 states, developed model legislation to unify and simplify sales and use tax administration among the states that adopt the legislation. The SSTP hopes that, by unifying and simplifying sales tax systems, Internet businesses will voluntarily collect sales taxes. The model legislation, entitled the Uniform Sales and Use Tax Administration Act (the Act), would authorize a state taxing authority to enter into an interstate contract, the Streamlined Sales and Use Tax Agreement (the Agreement). The Act and related Agreement would, among other matters, establish more uniform administrative standards, and develop and adopt uniform definitions of sales and use tax terms.

.44 The SSTP has now gathered half the states into its fold. The SSTP process consists of two parts. First, states must pass enabling legislation that allows tax administrators from the different states to work together to craft a new set of model sales tax laws. Second, states must individually amend their sales tax laws to

conform to the model legislation. As of April 1, 2002, 25 states and the District of Columbia have passed enabling legislation. The legislatures of eight other states have introduced the legislation.

.45 Recently, the Act ran into a snag when a task force of the National Conference of State Legislatures (NCSL) took significant exception to some of its measures. The NCSL drafted and distributed its own version of model legislation to simplify sales tax. State legislatures are now considering whether to adopt legislation and, if so, which version.

Help Desk—The Act is available on SSTP's Web site at www.streamlinedsalestax.org. The NCSL's version of the model legislation is available on the NCSL Web site at www.ncsl.org/programs/fiscal/tctelcom.htm. The NCSL site also includes a document that lists the amendments that the NCSL made to the SSTP Act.

Online Sales to European Union Consumers

.46 The European Union (EU) is in the process of adopting new rules that would require non-EU suppliers (including many U.S. companies) to collect and remit a value-added tax (VAT) on digital goods and services supplied to EU consumers. However, these new rules do not apply to non-EU suppliers selling to business customers in the union because existing self-assessment arrangements already cover VAT collection in these situations.

.47 Non-EU suppliers will have to register in an EU member state of their choice, and levy VAT at the rate applicable in the member state where the customer resides.

.48 **Goods and Services Included.** These new rules will apply to the online sale of digital products, such as software, music, games, databases, and broadcasts of events.

.49 The VAT situation will lead to discrepancies in taxation between digital goods and services and their tangible equivalents. Books, magazines, and newspapers physically available in the EU member states are taxed at reduced rates, or not at all. E-books or electronic subscriptions to newspapers or magazines provided by non-EU vendors will be subject to VAT under these new rules.

.50 **Thresholds.** There is no provision in these new rules for any sort of a *de minimis* amount; theoretically, a vendor with \$1 of digitized-goods sales in the EU would need to register and collect the VAT. In addition, each of the EU states can enact its own threshold amount. Currently, this can range from zero to approximately 85,000 euros (about \$75,000).

.51 **Documentation.** Under these new rules, a non-EU company must charge VAT based on the customer's location. The vendor would be required to verify the information concerning the purchasers and their locations. The vendor would be responsible if the individual consumer provided inaccurate or fraudulent information, even if it was accepted in good faith; a purchaser's declaration would not be sufficient. In addition, the vendor would presumably be responsible if there were discrepancies between the customer's ordering location and shipping address (for example, a customer purchased goods via the Internet while on vacation but had them delivered to his or her home address).

.52 **Collection.** Under these new rules, a U.S. company will have to register in one of the EU countries; however, the U.S. company will have to charge and collect VAT at the rate that applies in the country of consumption. Currently, there are 15 different rates, ranging from 15 percent (in Luxembourg) to 25 percent (in Sweden). Thus, a non-EU vendor will have to register in one country in the EU but collect VAT at the correct rate in 15 different countries.

.53 Such a requirement contrasts sharply with those imposed on EU vendors. In general, an EU vendor will have to charge VAT only at the rate that applies in the country where it (the seller) is established.

E-Signature Act

.54 In June 2000, the President signed into law the Electronic Signatures in Global and National Commerce Act (E-SIGN). E-SIGN contains provisions that ensure the legal validity of electronic (digital) signatures and contracts, permit the electronic delivery of legally required notices and disclosures, and allow for the satisfaction of record retention requirements through electronic means. An electronic signature can be “an electronic sound, symbol, or process, attached to or logically associated with a contract or record and executed or adopted by a person with the intent to sign the record.” Digital signatures are created and verified using cryptography, the science of encoding and unencoding data. The technique allows recipients of Web-based documents to identify the sender and be assured of the validity of electronically transmitted data.

.55 Even though such technology could vastly expand the realm of business that can be conducted electronically, adoption has been slow because of the lack of flexibility from older signature technologies. Recently, however, leading Internet security companies and top industry standards-setting bodies have settled on a more flexible way to verify electronic signatures for documents sent over the Web.

.56 The World Wide Web Consortium (W3C), the standards-setting body founded by Web co-inventor Tim Berners-Lee, said that the agreement would help Internet users to more safely share documents, fill out forms and trade images and other media. The W3C group said the XML (Extensible Markup Language) Signature Syntax and Processing standard is now ready to be incorporated into new products and services from companies such as Microsoft, IBM, VeriSign, and scores of other security software developers.

.57 XML Signature is designed to work with existing XML software, making it easier for modern software developers to incorporate the signature verification technology into new programs they develop.

Internet Privacy

.58 Advances in computer technology have made it possible to compile and share detailed information about people more easily and cheaply than ever. That situation can be good for society as a whole and for individual consumers as well. For example, it is easier for law enforcement to track down criminals, for banks to use electronic information to help detect and prevent fraud, and for consumers to learn about new products and services, allowing them to make better-informed purchasing decisions. At the same time, as personal information becomes more accessible, companies, associations, government agencies, and consumers must take precautions to protect against the misuse of that information. Along these lines, the privacy of information collected by operators of Web sites is a growing issue of concern.

.59 In the current Congress, there are more than 60 House bills and more than 30 Senate bills that address Internet privacy in whole or in part. Advocates of self-regulation argue that industry efforts, such as seal programs, for example, AICPA Trust Assurance Services (see the AICPA Web site, www.aicpa.org, for a detailed discussion), demonstrate the industry’s ability to police itself. However, advocates of legislation argue that, although the seal programs are useful, they do not carry the weight of law, limiting the remedies available to consumers whose privacy is violated. Auditors should monitor potential Internet privacy legislation closely and be prepared to advise their clients on compliance and other voluntary privacy efforts.

Help Desk—The Electronic Privacy Information Center tracks legislation and provides information on privacy, speech, and cyberliberties. Information is available at www.epic.org.

E-Fraud

.60 The Internet Fraud Complaint Center (IFCC), which began operation on May 8, 2000, is a partnership between the National White Collar Crime Center (NW3C) and the Federal Bureau of Investigation (FBI). The IFCC’s primary mission is to address fraud committed over the Internet. The mission is accomplished by facilitating the flow of information between law enforcement agencies and the victims of fraud—information that might otherwise go unreported.

.61 From January 1, 2001, to December 31, 2001, the IFCC Web site received 49,711 complaints. This total includes many different fraud types and nonfraudulent complaints: computer intrusions, SPAM/unsolicited e-mail, and child pornography. During this same time period, the IFCC referred 16,775 complaints of fraud, the majority of which was committed over the Internet or similar online service. The total dollar loss from all referred cases of fraud was \$17.8 million, with a median dollar loss of \$435 per complaint. Some significant findings of this report include:

- Internet auction fraud was by far the most reported offense, comprising 42.8 percent of referred complaints. Nondeliverable merchandise and payment account for 20.3 percent of complaints, and the Nigerian Letter Scam (individuals representing themselves as Nigerian or foreign government officials asking for help in placing large sums of money in overseas bank accounts) made up 15.5 percent of complaints. Credit and debit card fraud and confidence fraud (such as home improvement scams and multilevel marketing) round out the top five categories of complaints referred to law enforcement during the year. Among those individuals who reported a dollar loss, the highest median dollar losses were found among the Nigerian Letter Scam (\$5,575), identity theft (\$3,000), and investment fraud (\$1,000) complainants.
- Nearly 76 percent of alleged fraud perpetrators tend to be individuals (as opposed to businesses), 81 percent are male, and half reside in one of the following states: California, Florida, Illinois, New York, and Texas. Even though most are from the United States, perpetrators have a representation in Canada, Nigeria, Romania, and the United Kingdom.
- Of the male complainants, half are between the ages of 30 and 50 (the average age is 38.6), and over one-third resides in one of the four most populated states: California, Texas, Florida, and New York. Most are from the United States, but the IFCC has received a number of complaints from Canada, United Kingdom, Australia, and Japan.
- The amount of loss by complainants tends to be related to a number of factors. Business victims tend to lose more than individuals and males tend to lose more than females. This may be a function of both online purchasing differences by gender and the type of fraud in which individuals find themselves. Even though there isn't a strong relationship between age and loss, the proportion of individuals losing at least \$5,000 is higher for those 60 years and older than it is for any other age category.
- E-mail and Web pages are the two primary mechanisms by which the fraudulent contact took place. Nearly 70 percent of complainants reported they had e-mail contact with the perpetrator.

Help Desk—Further information on Internet fraud is available at the Internet Fraud Complaint Center Web site at <http://www1.ifccfbi.gov/index.asp>.

Extensible Business Reporting Language

.62 Extensible Business Reporting Language (XBRL) is a royalty-free, open specification for software that uses Extensible Markup Language (XML) data tags to describe financial information for public and private companies and other organizations. XBRL benefits all members of the financial information supply chain.

.63 XBRL:

- Is a standards-based method with which users can prepare, publish in a variety of formats, exchange, and analyze financial statements and the information they contain.
- Is a licensed royalty-free worldwide by XBRL International, a nonprofit consortium consisting of more than 140 leading companies, associations, and government agencies.
- Permits the automatic exchange and reliable extraction of financial information across all software formats and technologies, including the Internet.

- Benefits all users of the financial information supply chain: public and private companies, the accounting profession, regulators, analysts, the investment community, capital markets, and lenders, as well as key third parties, such as software developers and data aggregators.
- Does not require a company to disclose any additional information beyond that which it normally discloses under existing accounting standards. XBRL does not require a change to existing accounting standards.
- Improves access to financial information by improving the form of the information and making it more appropriate for the Internet.
- Reduces the need to enter financial information more than one time, reducing the risk of data entry error and eliminating the need to manually key information for various formats (for example, printed financial statement, an HTML document for a company's Web site, an EDGAR filing document, a raw XML file, or other specialized reporting formats, such as credit reports and loan documents), thereby lowering a company's cost to prepare and distribute its financial statements while improving investor or analyst access to information.
- Leverages efficiencies of the Internet as today's primary source of financial information. More than 80 percent of major U.S. public companies provide some type of financial disclosure on the Internet, and the majority of information that investors use to make decisions comes to them via the Internet.

.64 In October 2002, the XBRL-US Domain Working Group and the AICPA posted for public review a public working draft of the "U.S. Financial Reporting Taxonomy Framework" and "U.S. GAAP Commercial and Industrial Taxonomy." The "U.S. Financial Reporting Taxonomy Framework" provides a foundation that will be used in future taxonomy development; the "U.S. GAAP Commercial and Industrial Taxonomy" provides companies within that industry the ability to create XBRL financial statements.

Help Desk—Further information on XBRL is available at www.xbrl.org.

General Audit Issues and E-Business

.65 E-business is an ever more commanding presence in the lives of investors and businesses. The powerful force of e-business, in addition to its potential effect on the way we do business, directly affects practitioners and the avenues open to them as providers of services to the companies that engage in e-business. This electronic world is a unique and challenging frontier in many regards. It is an environment that will pose new demands on the auditors of both fledgling Web-play-only e-businesses and brick-and-mortar entities that are expanding their traditional business into e-business. Transactions conducted in an e-business environment may have a significant impact on audit process.

The Scope of E-Business Client Activities

.66 E-business activities can occur in many aspects of your clients' businesses. For this reason, you may need to search for information about your clients' e-business activities and consider their effects on your audit planning. Specific techniques to consider in the search for e-business activities include:

- Modifying engagement acceptance procedures to include questions about the client's e-business activities.
- Reviewing minutes of board meetings, paying particular attention to discussions about the entity's e-business strategy, related issues, and timing.
- Examining the entity's annual budget for information about e-business plans.
- Looking for unusual increases in other budget line items—marketing and technology budgets, for example.

- Performing transaction reviews.
- Performing inquiries as part of obtaining an understanding of the business.
- Searching the Internet and carefully reviewing the client's Web site.

Although not all-inclusive, these techniques may reveal evidence of the nature, scope, and depth of the client's e-business activities.

Audit Timing and Planning

.67 E-business transactions may automatically initiate, authorize, record, summarize, and settle electronically without human intervention or physical documentation. As a result, key audit evidence in electronic form may exist only for a limited amount of time. Therefore, you will need to understand and be able to rely on IT general controls. Computer programs may summarize transactions on a periodic basis and then purge, update, change, modify, or write over the original detail records of the transaction. Traditionally, audit procedures are performed after a client's fiscal year end. With e-business activities, however, traditional audit timing may be inadequate. One audit implication of sometimes short-term electronic evidence in e-business audits is that waiting until after the fiscal year end to begin auditing procedures may be too late to obtain competent sufficient evidence of controls or transactions.

.68 As noted in last year's Alert, SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311.09), indicates that "the extent to which computer processing is used in significant accounting applications, as well as the complexity of that processing, may also influence the nature, timing, and extent of audit procedures."

.69 Many e-businesses may not have hard-copy or paper evidence of transactions. Sales orders, purchase orders, invoices, delivery, settlement, and authorization may be prepared and performed electronically, leaving no paper trail behind. The failure of e-business companies to retain the details of transactions can create troublesome issues for the auditor who is considering whether internal control is functioning as planned. According to SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.18), as amended:

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. Therefore, the auditor should consider the time during which information exists or is available in determining the nature, timing, and extent of his or her substantive tests, and if applicable, tests of controls.

If the retention of evidential matter is questionable, the auditor may want to begin audit procedures before year end. This may also drive the need for continuous auditing.

Adequate Technical Training

.70 The rapid evolution of technology has profound implications for all those affected by computer technology, including auditors. Existing e-business hardware and software may need to be replaced every 18 months, or more frequently, to remain competitive. This rapid rate of technological change means that, to remain current, ongoing training in the underlying Internet technologies is requisite.

.71 Auditing through the computer and the nature of electronic evidence require that the auditor gain a more detailed understanding of the controls over transactions and records than that traditionally obtained for paper-based manual audits. Experienced auditors with traditional audit skills already have 60 percent to 80 percent of what is needed to audit e-business. You can obtain the balance of the more specific technology

skills through technical training courses, seminars, IT reference materials, research, and through other methods. You need look no further than SAS No. 1, section 210, *Training and Proficiency of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 210.04). The ubiquitous nature of e-business places even more demands on auditors than ever before.

Using the Work of a Specialist

.72 Due to the rapid advance of technology, you may not have all the skills necessary to audit e-business activities. Until you and your staff have the technical skills needed to audit e-business, you may need to engage IT audit specialists to perform certain procedures. Qualified IT specialists are sometimes available from another part of the firm, such as the consulting division or the internal IT support staff. If not, you may have to go outside your own organization to obtain qualified specialists.

.73 Engaging a specialist for gaining an understanding of internal controls, tests of controls, substantive tests, and analytical procedures requires awareness of guidelines available in the authoritative literature. According to SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336.06), specialized assistance is advisable for auditors who:

May encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skills or knowledge and in the auditor's judgment require using the work of a specialist to obtain competent evidential matter.

The use of an outside specialist³ in an e-business context does not absolve the auditor from a certain level of understanding about computers. Audit planning comes into play because of the lead time necessary to contract for a specialist's services and the time required for the auditor to obtain the minimum technological knowledge necessary to supervise the specialist. According to SAS No. 22 (AU sec. 311.10):

If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, that is, someone who may be either on the auditor's staff or an outside professional. If the use of such a professional is planned, the auditor should have sufficient computer-related knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified procedures will meet the auditor's objectives; and to evaluate the results of the procedures applied as they relate to the nature, timing, and extent of other planned audit procedures. The auditor's responsibilities with respect to using such a professional are equivalent to those for other assistants.

Internal Control as It Affects Audit Evidential Matter

.74 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance on the independent auditor's consideration of an entity's internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS). For traditional businesses, the auditor's consideration of internal control typically involves updating prior-year checklists, questionnaires, and procedural narratives. Using a traditional audit approach for e-business clients would be insufficient because, in the e-business environment, almost all of the evidence of transactions is electronic. Critical records may consist of e-mail, database records, electronic documents, spreadsheets, and server logs. In addition, e-business transactions are subject to intentional and unintentional alteration and manipulation at many points between transaction initiation and summarization in the financial statements. Because e-businesses generally lack much of the paper evidence found in audits of traditional businesses, your approach to understanding internal controls when planning the e-business audit and determining the nature and extent of substantive tests must take this into account.

³ Note that Statement on Auditing Standards (SAS) No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336), does not apply to specialists who are employed by the firm and are part of the engagement team. SAS No. 73 indicates that the auditor uses the work of the specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions. The specialist does not, however, perform the substantive tests or analytical procedures.

.75 SAS No. 55, as amended, provides guidance to auditors about the effect of IT⁴ on internal control and on the auditor's understanding of internal control and assessment of control risk. The Auditing Standards Board (ASB) believed the guidance was needed because entities of all sizes increasingly are using IT in ways that affect their internal control and the auditor's consideration of internal control in a financial statement audit. Consequently, in some circumstances, auditors may need to perform tests of controls to perform an effective audit.

.76 Remember that SAS No. 94 does not:

- Eliminate the alternative of assessing control risk at the maximum level and performing a substantive audit, if that is an effective approach.
- Change the requirement to perform substantive tests for significant account balances and transaction classes.

The Importance of Software Controls

.77 As noted earlier, technology continues to evolve rapidly. Most e-business server software is constantly upgraded, modified, and configured with components from different vendors. Often, when software is upgraded, previous control settings are lost, with no warning to managers. If procedures are performed before year end, you have the additional responsibility to consider whether there are frequent and significant changes being made to e-business systems that might affect the remainder of the period. According to SAS No. 55 (AU sec. 319.99):

When the auditor obtains evidential matter about the design or operation of controls during an interim period, he or she should determine what additional evidential matter should be obtained for the remaining period . . . The auditor should obtain evidential matter about the nature and extent of any significant changes in internal control, including its policies, procedures, and personnel, that occur subsequent to the interim period.

.78 Access is another issue to consider when testing controls over e-business activities. To test controls, auditors need access to networks, servers, and databases on which companies store their accounting records. Information technology managers may be reluctant to grant auditors the level of access they need, preferring, instead, to provide lengthy printouts, files on diskettes, or files as e-mail attachments. Access to copies of records in these forms is insufficient. E-business auditors must have full read-access rights to all system and database security settings and tables as well as the underlying electronic accounting records to gain a sufficient understanding of controls and to perform substantive tests. Sometimes this will require the CFO's involvement to obtain this access.

.79 We already know that e-business transactions may be initiated by a trading partner's software. If transactions are automatically initiated between customer and supplier computers, the trading parties should require an independent auditor's report on controls at the other party. (The report—an SAS No. 70 report—is described in the subsequent section of this Alert, "Reports From Service Organizations.")

.80 E-business software should include controls to prevent the repudiation or alteration of records that initiate transactions. Such controls might include digital signatures or server certificates that authenticate the parties to the transaction, as well as traditional edit and validation controls. Electronic (digital) signatures reduce the likelihood of the parties claiming that they never initiated the transaction or that the record of the terms of the transaction has been altered. Without server certificates, an initiator of a transaction has no

⁴ According to SAS No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), information technology (IT) encompasses automated means of originating, processing, storing, and communicating information, and includes devices, communication systems, computer systems (including hardware and software components and data), and other electronic devices.

assurance that it is dealing with the intended party's computer. Without digital signatures and server certificates, it may be difficult to determine that transactions are neither fictitious nor fraudulent. See the discussion of digital signatures in the "E-Signature Act" section in the "Recent Regulatory Developments" section of this Alert.

The Importance of Monitoring

.81 A key control in a system of internal control is monitoring. Routers, firewalls, Web servers, e-mail servers, databases, and operating systems all have the ability to log traffic and specific security events. Properly implemented and controlled logs can provide some evidence that a transaction occurred and that the transaction record has not been altered. Independent audits of the controls carried out at third parties, along with the use of digital certificates, encryption, access controls, and logging, help provide evidence for the auditor regarding the integrity of recorded transactions.

Key Controls in an Electronic Environment

.82 As noted in last year's Alert, to reduce the chance of an auditor relying on evidence that lacks credibility, he or she must understand the key controls over validity, completeness, and integrity. In the electronic environment, these typically include the following:

- *Segregation of duties.* Different employees should perform the duties of security administration, security monitoring, system administration, application maintenance, software development, and daily accounting operations.
- *Authorization.* User access to networks, systems, servers, services, programs, data, and records should be authorized based on the company's security policy and documented.
- *Authentication.* The identity of authorized users should be established by the use of logon IDs, hard-to-guess and hard-to-crack passwords, and, where appropriate, smart cards.
- *Access limitations.* Authorized users should be granted access to networks and application systems only after they authenticate themselves, and their access rights should be commensurate with their job responsibilities.
- *Activity logging.* Logging should be enabled on all routers, firewalls, servers, databases, and operating systems. The logs should be protected from tampering and alteration and should be retained.
- *Independent monitoring.* Employees independent of the IT department should monitor the activity logs on a frequent enough basis to detect suspicious, unusual, and unauthorized activity. Due to integration of e-business as discussed above, it should be independent of operations including IT.
- *Software development life cycle standards.* E-businesses should adopt and comply with authoritative standards for the development and implementation of new e-business systems.
- *Methods of error correction.* E-business software should have controlled rollback procedures so records are not purged or lost when servers crash and programs abort. Controls preventing changes to historical records should be in place so errors are corrected by entries made by the accounting department. Programmers and other IT personnel should not make changes to actual accounting records.
- *Backup procedures.* Grandfather, father, and son daily backup procedures should be performed, as well as weekly, monthly, quarterly, and annual backups. All files that include the details of transactions should be included in the backup. With the advice of legal counsel, the key user or owner of the data should establish retention schedules to satisfy legal and regulatory requirements. The backup media should have clear exterior identification, and there should be an offline log and inventory of what was backed up, when, by whom, and where stored. Backups should be stored in a safe location off-site and tested periodically by the key user of the data.

- *Disaster recovery.* The nature of e-business often requires that systems be capable of operating 24 hours a day, seven days a week. Even short periods of outage may mean significant financial loss to some e-businesses. There should be a written plan on how systems will roll over to alternative systems should the data center be destroyed or rendered inoperable. The plan should periodically be tested.

The strength of controls in an electronic environment is like a chain, where strength is determined by the weakest link. You should consider whether any weak links are present and, if so, consider the need to adjust your risk assessment and substantive tests accordingly.

Reports From Service Organizations

.83 Many clients use an ISP or application service provider (ASP) to host their Web site, including the databases used to initially record sales and credit card receivables. In a number of cases, ISP/ASP servers provide fulfillment by allowing users to immediately download their purchase after credit approval for software, digitized music, videos, books, and other electronic documents. For clients that use outsourced services, auditors can sometimes obtain a report on controls from the service organization. According to SAS No. 70, *Service Organizations* (AU sec. 324.24), the report would be either (1) reports on controls placed in operation, or (2) reports on controls placed in operation and tests of operating effectiveness.

.84 See the discussion about the recently published AICPA Audit Guide related to service organizations in the subsequent section of this Alert, “Audit Guide *Service Organizations: Applying SAS No. 70, as Amended.*”

IT Vendor Management

.85 IT vendor management provides clients with expert IT services that allow them to control direct labor costs and leverage their high volume to obtain more competitive rates. The scenario involves the management of IT vendors through effective controls and service level agreements.

.86 In the United States, many IT contractors are employed in vendor-management arranged deals. This trend is increasing because companies are operating on a global basis now and want to make use of their global buying power, so they outsource contractor employment to large vendor management companies.

.87 From an audit perspective, you should understand and review not only the performance of the IT vendor manager, but also the impact of vendor management controls over e-business operations. This has been a major issue during the past year in the financial services industry.

Current Audit Issues and Developments

Assessing Audit Risks in the Current Environment

.88 The proper planning and execution of an audit have always required you to have a thorough understanding of e-business and the nature of your client’s business. For most audit firms, this in-depth understanding means that the most experienced partners and managers must become involved early and often in the audit process. In today’s economic environment, your judgment, knowledge, and experience are even more important than they were in the past.

.89 During the past several months, the U.S. economy has suffered significant declines and uncertainties: Consumer confidence has dropped, plant closings and layoffs have increased dramatically, profit margins for many companies have slipped, and many companies have failed. Periods of economic uncertainty like this lead to challenging conditions for companies due to potential deterioration of operating results, increased external scrutiny, and reduced access to capital. During such times, professional skepticism should be heightened, and the status quo should be challenged.

Evaluating Audit Risks

.90 Your evaluation of audit risk should start with a good understanding of your client's business. To develop this understanding, you 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.

Professional Skepticism

.91 The third general audit standard stipulates that due professional care be exercised in planning and conducting an audit engagement. Due professional care requires that you exercise professional skepticism in gathering and evaluating audit evidence. Although you assume neither management dishonesty nor unquestioned honesty, you should consider the increased risk associated with the potential increases in external pressure on management during the current economic climate. For a more detailed discussion of these risks, see the "Consideration of Fraud" section of this Alert.

.92 *Earnings Management Challenges.* As a result of perceived external pressures, companies may be tempted to manage earnings by using nonrecurring transactions or changing the method of calculating key estimates, such as reserves, fair values, or impairments. Companies may also adopt inappropriate accounting practices resulting in improper recognition or omission of financial transactions. For material nonrecurring transactions that may require special disclosure to facilitate the readers' understanding of the reported financial results, apply the guidance in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, in reporting the effects of changes in estimates. Inappropriate transactions or accounting practices that may result in errors requiring adjustments of financial statements include, for example, premature recognition of revenue, failure to appropriately accrue for contingent liabilities that are probable and estimable, and failure to record unpaid purchase invoices. As mentioned earlier in this Alert, the use of outsourcing deals may affect current financial performance. Additionally, you should be particularly skeptical of fourth-quarter events that result in significant revenue recognition, loss accrual, or noncash earnings.

.93 The appropriate level of professional skepticism is needed when corroborating management's representations. Management's explanations should make business sense. Additionally, you may need to consider corroborating management's explanations with members of the board of directors or the audit committee.

.94 *Indicators of Reporting Risk.* Other indicators of potential increased accounting and reporting risk calling for increased professional skepticism include:

1. Liquidity matters
 - The company is undercapitalized, relying heavily on bank loans and other credit, and is in danger of violating loan covenants.
 - The company appears to be dependent on an initial public offering for future funding.
 - The company is having difficulty obtaining or maintaining financing.
 - The company is showing liquidity problems.
2. Quality of earnings
 - The company is changing significant accounting policies and assumptions to less conservative ones.
 - The company is generating profits, but not cash flow.
3. Management characteristics
 - Management's compensation is largely tied to earnings or appreciation of stock options.
 - The company appears vulnerable to the weakening economic conditions and management is not proactive in addressing changing conditions.

- The company's management is selling their investment in company securities more than in the past.
- There is a significant change in members of senior management or the board of directors.

Long-Lived Assets, Including Goodwill and Intangibles

.95 Industry downturns and cash flow erosion may indicate an impairment of fixed assets, goodwill, or other intangibles. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, provides guidance in this area. In that regard, significant idle equipment or assets no longer used in operations may need to be written off. (See the "Asset Impairment" subsection later in this Alert for related information.)

.96 FASB Statement No. 142, *Goodwill and Other Intangible Assets*, was issued in June 2001. This Statement requires that goodwill be tested for impairment at least annually using a two-step process that begins with an estimation of the fair value of a reporting unit. The first step is a screen for potential impairment, and the second step measures the amount of impairment, if any.

.97 In addition, FASB Statement No. 142 provides specific guidance on testing intangible assets that are not being amortized for impairment and thus removes those intangible assets from the scope of other impairment guidance. Intangible assets that are not amortized are tested for impairment at least annually by comparing the fair values of those assets with their recorded amounts.

Debt

.98 You should carefully review loan agreements and test for compliance with loan covenants. In this regard, consider any "cross default" provisions, that is, a violation of one loan covenant that affects other loan covenants. Keep in mind that any debt with covenant violations that are not waived by the lender for a period of more than one year from the balance sheet date may need to be classified in the balance sheet as a current liability.

.99 As always, review the debt payment schedules and consider whether the company has the ability to pay current debt installments or to refinance the debt if necessary. When making an evaluation, it is important to remember that it is quite possible that the company will not generate as much cash flow as it did in previous years.

Going Concern

.100 As you plan and perform audits of e-business activities, you should consider general economic factors that give rise to going-concern issues. For example, reductions in personal income, layoffs, higher unemployment levels, changing or outdated technology, and decreases in consumer confidence all give rise to such concerns. These factors have combined recently to result in high rates of business failure. Accordingly, auditors should be alert to general economic and other conditions and events which, when considered in the aggregate, indicate that there could be substantial doubt about the entity's ability to continue as a going concern.

.101 In general, conditions and events that might indicate caution about going-concern issues could include (1) negative trends, such as recurring operating losses (2) financial difficulties, such as loan defaults or denial of trade credit from suppliers (3) internal challenges, such as substantial dependence on the success of a particular product line or service (4) external matters, such as pending legal proceedings or the loss of a principal supplier or (5) the inability to retain key technical or managerial talent. Also consider the possibility of the entity's excessive and unusual reliance on external financing, rather than money generated from the company's own operations as a going-concern issue. External financing reliance is one major factor that led to the many of the failures of dot-com companies.

.102 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. 341.02-.04). That Statement provides guidance about conducting an audit of financial statements in accordance with GAAS to evaluate whether there is substantial doubt about a client's ability to continue as a going concern for a reasonable period of time.

.103 Information that significantly contradicts the going-concern assumption, or the ability to remain a going concern, 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 you to design audit procedures solely to identify conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

.104 If there is substantial doubt about the entity's ability to continue as a going concern, consider the likelihood that management plans can mitigate existing conditions and events and whether those plans can be effectively implemented. If you obtain sufficient competent evidential matter to alleviate doubts about going-concern issues, then consider the need for disclosures of the conditions and events that initially caused you to believe there was substantial doubt.⁵ If, however, after considering identified conditions and events, along with management's plans, you conclude that substantial doubt remains about the entity's ability to continue as a going concern, consider the possible effects on the financial statements and the adequacy of the related disclosure. Additionally, the audit report should include an explanatory paragraph to reflect your conclusion. In these circumstances, refer to the specific guidance set forth under SAS No. 59.

E-Businesses in Bankruptcy Reorganization

.105 For those e-business entities or operations that are under bankruptcy reorganization pursuant to Chapter 11 of the Bankruptcy Code, or emerging from it, consider whether the company is following the accounting guidance of Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*. E-business entities that filed for bankruptcy may have impairments that need to be recorded before fresh-start accounting under SOP 90-7.

Consideration of Fraud

.106 Recently, the ASB issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), which supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316A); amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230); and amends SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333).

.107 SAS No. 99 addresses the following issues:

- Description and characteristics of fraud
- The importance of exercising professional skepticism
- Discussion among engagement personnel regarding the risks of material misstatement due to fraud
- Obtaining the information needed to identify risks of material misstatement due to fraud
- Identifying risks that may result in a material misstatement due to fraud

⁵ Note that SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), amended 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), to require that this evidence be documented.

- Assessing the identified risks after taking into account an evaluation of the entity's programs and controls
- Responding to the results of the assessment
- Evaluating audit evidence
- Communicating about fraud to management, the audit committee, and others
- Documenting the auditor's consideration of fraud

.108 According to SAS No. 99, fraud frequently involves a pressure or incentive to commit fraud. The lack of industry self-regulation of e-business and, in some cases, the lack of established accounting practices relative to the industry could provide management with the opportunity to manipulate income.

.109 SAS No. 99 specifically recognizes certain conditions as risk factors that motivate management to engage in fraudulent financial reporting. For example, factors include situations in which a significant portion of management compensation is represented by bonuses, stock options, or other incentives; and ones in which there is an excessive interest by management in maintaining or increasing an entity's stock price. SAS No. 99 also identifies other risk factors related to misstatements arising from fraudulent financial reporting, such as a high degree of competition or market saturation, and rapidly changing technology or rapid product obsolescence. All of these factors are present in the e-business environment, implying potential audit concerns.

.110 As a result of the opportunity for fraud that is present in audits of e-businesses, you should consider whether specific controls exist that mitigate the risks. Mitigating controls at larger companies may include an effective board of directors, audit committee, and an internal audit function. Smaller companies may have an environment that fosters integrity and ethical behavior, as well as management by example.

.111 You may need to modify the nature, timing, and extent of audit procedures if you believe that there are risks of material misstatement attributable to fraud during an audit of an e-business. For example, you may choose to perform detailed substantive analytical procedures or conduct interviews in areas where fraud may be present, or both. For potential fraud related to revenue recognition issues, you may decide to confirm certain relevant terms of customer contracts. SAS No. 99 contains specific guidance on revenue recognition as a potential fraud risk.

.112 In certain situations, you may have a duty to disclose the circumstances of the fraud to outside parties. For public companies, if the fraud or related risk factor results in termination of the engagement, is considered a reportable event, or is the source of a disagreement, you may be required to report this situation to the SEC. If fraud is present, other reports also may be required under section 10A(b)1 of the Securities and Exchange Act of 1934.

.113 For more information on SAS No. 99, see the discussion in the "Recent Auditing and Attestation Pronouncements and Other Guidance" section later in this Alert.

General Accounting Issues Affecting E-Business

.114 Accounting for e-business involves the application of many complex accounting principles and transactions for which there may be diversity in practice or no authoritative guidance. The diversity in accounting treatment for e-business transactions leads to incomparable financial statements and potential earnings-management issues and may cause investors to rely on unaudited sources of information for stock valuation and investment decisions.

.115 Accounting regulators and standard-setters are aware of the issues raised by the diversity in accounting by e-businesses. In addition, the SEC staff has identified several accounting issues for Internet companies that the Emerging Issues Task Force (EITF) is addressing. See the section in this Alert titled “SEC Internet-Related Concerns” for a discussion of these issues.

Stock Options

.116 As noted in last year’s Alert, stock options are an important accounting-related area for your e-business clients. Knowledgeable workers are the prime assets of e-businesses and are the key to wealth creation. Accounting for their compensation sometimes raises difficult accounting issues if e-businesses include stock options in employee compensation packages. E-businesses grant stock options to essential employees to attract, motivate, and retain them, in addition to granting stock options, awards of stock, or warrants to consultants, contractors, vendors, lawyers, finders, lessors, and others. Issuing equity instruments makes a lot of sense, partly because of the favorable accounting treatment and partly because the use of equity conserves cash and generates capital.

.117 The accounting for employee stock options has received renewed attention in recent months. There have been two important developments. First, several major U.S. companies have announced their intentions to change their method of accounting for employee stock options to an approach that recognizes an expense for the fair value of the options granted in arriving at reported earnings. Recognizing compensation expense relating to the fair value of employee stock options granted is the preferable approach under FASB Statement No. 123, *Accounting for Stock-Based Compensation*. It also is the treatment advocated by an increasing number of investors and other users of financial statements.

.118 When the FASB developed FASB Statement No. 123 in the mid-1990s, the FASB proposed requiring that treatment because it believed it was the best way to report the effect of employee stock options in a company’s financial statements. The FASB modified that proposal in the face of strong opposition by many in the business community and in Congress who directly threatened the existence of the FASB as an independent standard setter. Thus, while FASB Statement No. 123 provides that expense recognition for the fair value of employee stock options granted is the preferable approach, it permitted the continued use of existing methods with disclosure in the footnotes to the financial statements of the pro forma effect on net income and earnings per share as if the preferable, expense recognition method had been applied. Until now, only a handful of companies elected to follow the preferable method. (See related information in the subsequent section of this Alert, “FASB Issues EDs Related to Stock-Based Compensation.”)

.119 Second, the International Accounting Standards Board (IASB) has concluded its deliberations on the accounting for share-based payments, including employee stock options, and announced plans to issue a proposal for public comment in the fourth quarter of 2002. That proposal would require companies using IASB standards to recognize, starting in 2004, the fair value of employee stock options granted as an expense in arriving at reported earnings. Although there are some important differences between the methodologies in the IASB proposal and those contained in FASB Statement No. 123, the basic approach is the same—fair value measurement of employee stock options granted with expense recognition over the vesting period of the options. See information related to FASB exposure drafts about stock options (stock-based compensation) in the “On the Horizon” section of this Alert.

Business Combinations

.120 In June 2001, the FASB issued FASB Statement No. 141, *Business Combinations*, to address financial accounting and reporting issues for business combinations. This Statement supersedes APB Opinion No. 16, *Business Combinations*, and FASB Statement No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*. Under FASB Statement No. 141, all business combinations will be accounted for using one method—the purchase method. Given the economic environment of e-business, mergers and acquisitions have been prevalent, so this change to a single method of accounting for business combinations may have major implications for e-businesses.

.121 Under APB Opinion No. 16, business combinations were accounted for using one of two methods, namely, the pooling-of-interests method (pooling method) or the purchase method. Use of the pooling method was required whenever 12 criteria were met; otherwise, the purchase method was used. Because those 12 criteria did not distinguish economically dissimilar transactions, similar business combinations were accounted for using different methods, producing dramatically different results.

.122 The provisions of FASB Statement No. 141 reflect a fundamentally different approach to accounting for business combinations. The single-method approach reflects the conclusion that virtually all business combinations are acquisitions and, thus, all business combinations should be accounted for in the same way that other asset acquisitions are accounted for—based on the values exchanged. Specifically, FASB Statement No. 141 changes the accounting for business combinations in APB Opinion No. 16 in the following respects:

- FASB Statement No. 141 requires that all business combinations be accounted for by a single method—the purchase method.
- In contrast to APB Opinion No. 16, which required the separate recognition of intangible assets that can be identified and named, FASB Statement No. 141 requires that intangible assets be recognized as assets apart from goodwill if they meet one of two criteria—either the contractual-legal criterion or the separability criterion.
- In addition to the disclosure requirements in APB Opinion No. 16, FASB Statement No. 141 requires the disclosure of the primary reasons for both the business combination and the allocation of purchase price paid to the assets acquired and liabilities assumed by major balance-sheet caption.

.123 The provisions of FASB Statement No. 141 apply to all business combinations initiated after June 30, 2001. The Statement also applies to all business combinations accounted for using the purchase method for which the date of acquisition is July 1, 2001, or later.

SEC Internet-Related Concerns

.124 The SEC staff expressed concern about issues that they believed warranted consideration by the EITF or another standard-setting body. Since 1999, the SEC and the EITF have worked to resolve these issues, which we discuss here.

Rebates and Free Products or Services

.125 ISPs and computer retailers commonly offer a rebate to purchasers of new computers who contract for three years of Internet service. In most cases, the rebate cost is borne by the ISP while a portion is borne by the retailer. In addition, the retailer provides advertising and marketing for the arrangement, and the rebate must be returned by the consumer if the consumer breaks the contract with the ISP. Some ISPs and retailers believe their portion of the cost of the rebate should be a marketing expense, as opposed to a reduction of revenues. However, according to SEC's Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers*, the SEC staff generally believes that such rebates should be considered a reduction of revenue.

.126 On a related matter, some e-businesses offer free or heavily discounted products or services in introductory offers (for example, a free month of service or six CDs for a penny). Some businesses conclude that these introductory offers should be accounted for at full sales price, with the recognition of marketing expense for the discount. The section titled "One-Cent Sales" in AICPA Technical Practice Aid *Revenue Recognition* (AICPA, *Technical Practice Aids*, vol. 1, TIS sec. 5100.07) addresses this issue, concluding, "The practice of crediting sales and charging advertising expense for the difference between the normal sales price and the 'bargain day' sales price of merchandise is not acceptable for financial reporting."

.127 The FASB's EITF addressed these issues in EITF Issue No. 00-14, concluding that sales incentives, such as rebates and free products, should be treated as a reduction of revenue.

Auction Site Fees

.128 Internet auction sites usually charge both up-front (listing) fees and back-end (transaction-based) fees. In many cases, the listing fees are being recognized as revenue when the item is originally listed, despite the requirement for the auction site to maintain the listing for the duration of the auction. In addition, some auction sites recognize the back-end fees as revenue at the end of the auction despite the fact that the seller is entitled to a refund of the fee if the transaction between the seller and the buyer does not close. According to the SEC's SAB No. 101, the SEC staff generally believes that the up-front (listing) fees should be recognized over the listing period, which is the period of performance. Because the facts and circumstances of the agreements among the auction site, the buyers, and the sellers may vary significantly concerning the back-end fees, each situation will have to be evaluated to determine the appropriate method of revenue recognition.

Application Service Providers

.129 Some purchasers of software do not actually receive the software. Rather, the software application resides on the vendor's or a third party's server, and the customer accesses the software on an as-needed basis over the Internet. Essentially, the customer is paying for two elements—the right to use the software and the storage of the software on someone else's hardware. The latter service is referred to as *hosting*. If the vendor also provides the hosting, several revenue recognition issues may arise. First, there may be transactions structured in the form of a service agreement providing Internet access to the specified site, without a corresponding software license. In such instances, it may not be clear how to apply SOP 97-2, *Software Revenue Recognition*. Second, if the transaction is viewed as a software license with a service element, it is not clear how to evaluate the delivery requirement of SOP 97-2.

.130 The EITF addressed this topic in EITF Issue No. 00-3, *Application of AICPA Statement of Position 97-2, Software Revenue Recognition, to Arrangements That Include a Right to Use Software Stored on Another Entity's Hardware*. The consensus of the EITF was that SOP 97-2 does not apply to all of these arrangements, but if it does, revenue should be allocated to the software element based on vendor-specific evidence of fair value. Revenue should be recognized on the software element when the delivery has occurred and on the hosting element when the services are performed.

Web Site Access and Maintenance

.131 Some e-businesses provide customers with services that include access to a Web site, maintenance of a Web site, or the publication of certain information on a Web site for a period of time.⁶ Some companies have argued that, because the incremental costs of maintaining the Web site and/or providing access to it are minimal, this ongoing requirement should not preclude up-front revenue recognition. According to the SEC's SAB No. 101, the SEC staff believes, however, that fees like this should be recognized over the performance period, which would be the period over which the company has agreed to maintain the Web site or listing.

Accounting for Customer or Membership Base Costs

.132 E-businesses often make large investments in building a customer or membership base. Consider the following examples:

- Sites that give users rewards, such as points, products, discounts, and services, in exchange for setting up an account with the site
- Sites that make payments to business partners for referring new customers or members
- Businesses that give users a computer and Internet service for free if they are willing to spend a certain amount of time on the Internet each month and are willing to have advertisements reside permanently on their computers

⁶ EITF Issue No. 00-2, *Accounting for Web Site Development Costs*, describes the accounting treatment for costs associated with developing a Web site.

In each of these examples, a question may arise about whether the costs represent customer acquisition costs or the costs of building a membership base that qualifies for capitalization, for example, by analogy to FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, as amended.

.133 The EITF has not reached a consensus on Issue No. 00-22, *Accounting for "Points" and Certain Other Time-Based or Volume-Based Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future*, although it still plans further discussion. Specific industries would be excluded from the scope of EITF Issue No. 00-22 to the extent that they are addressed by higher level GAAP; however, not much guidance currently exists.

Other E-Business Accounting Issues Important to Investors

.134 E-business analysts have identified several essential e-business accounting issues of interest to auditors. These issues are presented from the point of view of investors evaluating Internet companies.

Recognition of Costs

.135 Customer solicitation and software development costs are key costs for e-businesses that present cost recognition issues. Currently, there is diversity in accounting for these costs by Internet companies—they could either capitalize or expense the costs—which makes it difficult to compare their financial statements.⁷ If they capitalize the costs, amortization periods for essentially the same transactions could differ between companies. Compounding the problem is the practice by some established companies of masking these costs by spreading them across existing operations.

.136 If alternative accounting treatments give management the ability to choose between capitalizing or expensing a cost, management may use the alternatives to manage earnings. If investors cannot compare audited financial statements reliably, they may turn to potentially unreliable sources of information as a basis for their investment decisions. The use of unreliable information can cause volatility in the stock prices, misvaluation, and losses for investors.

.137 In the two major categories of customer solicitation and software development costs, auditors should be aware of current GAAP, as follows:

- SOP 93-7, *Reporting on Advertising Costs*
- EITF Issue No. 00-22, *Accounting for "Points" and Certain Other Time-Based or Volume-Based Incentive Offers, and Offers for Free Products or Services to Be Delivered in the Future*
- SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*
- EITF Issue No. 00-2, *Accounting for Web Site Development Costs*

Research and Development Costs

.138 The e-business industry is still in its infancy. Often, the competitive advantage of an e-business rests on an idea that is still in the conceptual stage, with no existing commercial software process to implement the strategy. Therefore, many e-businesses undertake the research and development (R&D) activities themselves.

.139 Ongoing innovation is the heart of competition in e-business and is required for survival. Consequently, most e-businesses devote a substantial portion of their resources to R&D activity. According to paragraphs 8(a) and 8(b) of FASB Statement No. 2, *Accounting for Research and Development Costs*:

⁷ If the costs incurred relate to internal-use software, Statement of Position (SOP) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* requires that these costs be capitalized and amortized over the useful life of the software.

Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service.

Development is the translation of research findings or other knowledge into a plan or design for a new product or process . . . whether intended for sale or use.

.140 E-business management may reduce net loss or increase earnings by capitalizing R&D costs, which are significant for many companies involved in e-business. However, FASB Statement No. 2, as interpreted by FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, prohibits capitalization and requires R&D to be expensed when incurred, except for acquired R&D with alternative future uses purchased from others. In addition to the requirement to expense internal R&D, FASB Statement No. 2 requires disclosure in the financial statements regarding the total amount of R&D costs charged to expense.

.141 Some e-businesses acquire their assets through mergers and acquisitions. One purpose of these business combinations is to acquire in-process e-business R&D. You may need to hire a technology specialist to determine which acquired technology objects have alternative future uses. For clients with technology with alternative future uses, you should verify that they are properly valued and capitalized.

Help Desk—The AICPA Practice Aid titled *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries* (product no. 006609kk) may be helpful in valuing these intangible assets. It is available from the AICPA Order Department at (888) 777-7077 or online at www.cpa2biz.com.

Contingency Losses

.142 E-businesses that conduct retail transactions over the Internet with consumers might experience contingent losses for sales returns, allowances, and credit card chargebacks. Auditors of e-businesses should ensure that clients conducting online retail sales accrue an adequate loss contingency for sales returns, allowances, and credit card chargebacks, or that they make adequate disclosure that they cannot reasonably estimate the amount of loss.

.143 Usually, estimates of anticipated losses are based on the normal experience of the business and its transaction history. For many e-businesses, however, there is not enough transaction history to reasonably estimate these amounts. In that case, according to paragraph 10 of FASB Statement No. 5, *Accounting for Contingencies*:

If no accrual is made for a loss contingency because one or both of the conditions in paragraph 8 [see previous extract] are not met . . . disclosure of the contingency shall be made where there is at least a reasonable possibility that a loss . . . may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made.

Start-Up Activity Costs

.144 As a result of the recent pace of e-business investment, you should take the time to understand how to apply the provisions of SOP 98-5, *Reporting on the Costs of Start-Up Activities*, for your clients. In addition, you may want to review the provisions of FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*. Paragraph 5 of SOP 98-5 defines start-up activities as:

Those one-time activities related to opening a new facility, introducing a new product or service, conducting business with a new class of customer or beneficiary, initiating a new process in an existing facility, or commencing some new operation. Start-up activities include activities related to organizing a new entity (commonly referred to as organization costs).

.145 Certain costs that ongoing enterprises would be able to capitalize under GAAP, such as acquiring or constructing long-lived assets and getting them ready for their intended uses, acquiring or producing inventory, and acquiring intangible assets, are not subject to SOP 98-5. Costs of start-up activities, including organization costs, should be expensed as incurred.

.146 FASB Statement No. 7 defines a development stage enterprise as one that is devoting substantially all of its efforts to establishing a new business, whose principal operations have not commenced, or for which there is no significant revenue. In addition, a development stage enterprise typically devotes most of its activities to acquiring or developing operating assets, recruiting and training personnel, and developing markets, as well as other activities. Clearly, FASB Statement No. 7 applies to most new e-businesses because they are typically involved in the activities described by the Statement. According to paragraph 10 of FASB Statement No. 7:

Financial statements issued by a development stage enterprise shall present financial position and results of operations in conformity with the generally accepted accounting principles that apply to established operating enterprises.

.147 Furthermore, FASB Statement No. 7 requires additional balance-sheet disclosures. These disclosures include cumulative net losses, with special descriptive captions, income statement disclosure of cumulative revenue and expenses, and a statement of stockholder equity showing each issuance of equity securities, including dollar amounts, dollar amounts assigned for noncash consideration, the nature of noncash consideration, and the basis for assigning amounts.

.148 The applicability of FASB Statement No. 7 is especially important for new e-businesses that might be tempted to play by their own rules, and to pick and choose between what to report and disclose. Public development stage companies are subject to article 5A of SEC Regulation S-X, which requires separate statements of assets and unrecovered promotional and development costs. Rule 12-06a of Regulation S-X allows the offset of certain proceeds and other income against promotional and development costs.

Footnote Disclosures

.149 Under current GAAP, there are no special reporting or disclosure requirements specifically related to e-business. On the other hand, SEC reporting companies with multiple operating segments are required to report and disclose financial and descriptive information about reportable operating segments. According to paragraphs 3 and 4 of FASB Statement No. 131, *Disclosures About Segments of an Enterprise and Related Information*:

The objective of requiring disclosures about segments of an enterprise and related information is to provide information about different types of business activities in which an enterprise engages and the different economic environments in which it operates to help users of financial statements better understand the enterprise's performance, better assess its prospects for future net cash flows, and make more informed judgments about the enterprise as a whole.

The method the Board chose for determining what information to report is referred to as the management approach . . . [which is] based on the way that management organizes the segments within the enterprise for making operating decisions and assessing performance.

.150 Information about the e-business activities of public companies is important and valuable information to investors. Reliable financial information about the nature of a company's e-business activities is crucial to assessing that company's future prospects. E-business activities may meet the guidelines for an operating segment, according to paragraph 10 of FASB Statement No. 131, if one of the following occurs:

- The segment engages in activities from which it may earn revenues and incur expenses.
- The enterprise's chief operation decision-maker regularly reviews its operating results.
- There is discrete financial information available.

.151 Further, these e-business activities that meet the definition of operating segments may meet the guidelines for a reportable segment (segments for which specific disclosures are required), according to paragraph 18 of FASB Statement No. 131, if the following occur:

- The segment's reported revenue to both external customers and intersegment sales is 10 percent or more of the combined revenue of all operating segments;
- The absolute amount of reported profit or loss is 10 percent or more of the combined operating profit or loss; or
- Its assets are 10 percent or more of the combined assets of all operating segments.

.152 FASB Statement No. 131 is not intended to discourage the disclosure of additional information about e-business activities. Audited information disclosed in the notes to the financial statements that investors may use to value e-business companies, such as Web site traffic, growth in customer base, customer retention ratios, and employee turnover, could help dampen stock market volatility by improving the quality of information available to investors.

.153 On a related matter, as noted in the "Long-Lived Assets, Including Goodwill and Intangibles" section of this Alert, FASB Statement No. 142, *Goodwill and Other Intangible Assets*, requires public and nonpublic companies to test goodwill for impairment at least annually at the "reporting unit" level. A reporting unit is defined as "an operating segment or one level below an operating segment." FASB Statement No. 142 further requires specific disclosures about goodwill and other intangible assets at the reporting unit or operating segment level.

Asset Impairment

.154 Moving sales and distribution networks to the Internet can displace existing traditional distribution channels, deconstruct industries and companies, and cause assets to lose significant value. For example, e-business can threaten existing branch office operations, travel agencies, bookstores, stockbrokers, insurance agents, music distributors, automobile dealerships, and newspaper classified advertising departments. Where does the auditor come into play in all of this? Auditors of businesses subject to deconstruction by the Internet need to consider whether management has appropriately accounted for asset values that have been impaired. FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, provides you with some relevant guidance.

.155 FASB Statement No. 144 supersedes FASB Statement No. 121 and the accounting and reporting provisions of APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual, and Infrequently Occurring Events and Transactions*, for the disposal of a segment of a business (as previously defined in the Opinion). This Statement also amends ARB 51, *Consolidated Financial Statements*, to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary.

.156 FASB Statement No. 144 retains the requirements of FASB Statement No. 121 to (1) recognize an impairment loss only if the carrying amount of a long-lived asset is not recoverable from its undiscounted cash flows and (2) measure an impairment loss as the difference between the carrying amount and the fair value of the asset. To resolve implementation issues, the Statement:

- Removes goodwill from its scope and, therefore, eliminates the requirement of FASB Statement No. 121 to allocate goodwill to long-lived assets to be tested for impairment.

- Describes a probability-weighted cash-flow estimation approach to address situations in which alternative courses of action to recover the carrying amount of a long-lived asset are under consideration or a range is estimated for the amount of possible future cash flows.
- Establishes a “primary asset” approach to determine the cash-flow estimation period for a group of assets and liabilities that represents the unit of accounting for a long-lived asset to be held and used.

.157 The accounting model for long-lived assets to be disposed of by sale is used for all long-lived assets, whether previously held and used or newly acquired. That accounting model retains the requirement of FASB Statement No. 121 to measure a long-lived asset classified as held for sale at the lower of its carrying amount or fair value less cost to sell and to cease depreciation. Therefore, discontinued operations are no longer measured on a net realizable value basis, and future operating losses are no longer recognized before they occur.

.158 According to paragraph 8 of FASB Statement No. 144:

A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable.

.159 A significant adverse change in the business climate is one example that paragraph 8 of FASB Statement No. 144 provides to determine whether it is necessary to assess the recoverability of an asset. Some assets, particularly legacy software and hardware systems, or even relatively recently installed enterprise resource planning, network operating, and software systems, have been rendered obsolete by changing technology and may have fair values that are significantly less than book value. In addition to single assets, FASB Statement No. 144 also applies to groups of assets.

.160 The provisions of FASB Statement No. 144 are effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years, with early implementation encouraged. The provisions of the Statement generally are to be applied prospectively.

Recent Auditing and Attestation Pronouncements and Other Guidance

.161 Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year’s Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 95	<i>Generally Accepted Auditing Standards</i>
SAS No. 96	<i>Audit Documentation</i>
SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i>
SAS No. 100	<i>Interim Financial Information</i>

(continued)

SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>
SSAE No. 11	<i>Attest Documentation</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i>
SQCS No. 6	<i>Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>
Audit Guide	<i>Service Organizations: Applying SAS No. 70, as Amended</i>
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i>
Audit Interpretation No. 4 of SAS No. 70	"Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls"
Audit Interpretation No. 5 of SAS No. 70	"Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods"
Audit Interpretation No. 12 of SAS No. 1, section 420	"The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Change in the Year of Adoption"
Audit Interpretation No. 14 of SAS No. 58	"Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing"
Auditing Interpretation No. 15 of SAS No. 58	"Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations"
Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Practice Alert 02-1	<i>Communications With the Securities and Exchange Commission</i>
Practice Alert 02-2	<i>Use of Specialists</i>
Practice Alert 02-3	<i>Reauditing Financial Statements</i>
Practice Aid	<i>Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide</i>
Practice Aid	<i>New Standards, New Services: Implementing the Attestation Standards</i>
Practice Aid	<i>Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users</i>

.162 The following summaries of available guidance might have particular significance in the e-business environment. The summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standards. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*

.163 As noted previously in the “Consideration of Fraud” section of this Alert, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316A); amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230); and amends SAS No. 85, *Management Representations*. The Statement does not change the auditor’s responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02).⁸ However, SAS No. 99 establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.⁹

.164 Among other things, SAS No. 99 also includes Exhibit 1, “Management Antifraud Programs and Controls: Guidance to Help Prevent, Detect, and Deter Fraud.” This document was developed by the AICPA and other sponsoring organizations to assist management, audit committees, and board of directors to better understand the types of programs and controls that would be effective in preventing and deterring fraud. The document has been included with the SAS to assist auditors in obtaining an understanding of programs and controls that management and those with corporate governance responsibility may use to mitigate specific risks of fraud, or that otherwise help to prevent, deter, and detect fraud. SAS No. 99 also revises the guidance for management representations about fraud currently found in SAS No. 85, *Management Representations*.

.165 SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application is permissible. (See related discussion in the previous section of this Alert, “Consideration of Fraud.”)

.166 The AICPA is completing a fraud Practice Aid titled *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide* that will be published by the end of 2002. The Practice Aid addresses such topics as how the new SAS changes audit practice, characteristics of fraud, understanding the new SAS, best practices, and practice aids, including specialized industry fraud risk factors, common frauds, and extended audit procedures. Auditors should be on the lookout for this new publication.

Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*

.167 The objective of this Guide recently issued by the AICPA is to help auditors implement SAS No. 70, as amended. Guidance included is for service auditors engaged to issue reports on a service organization’s controls that may be part of a user organization’s information system in the context of an audit of financial statements. In addition, the guidance is for user auditors engaged to audit financial statements of entities that use service organizations.

⁸ 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* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). 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 (see SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 312]), or fraud.

⁹ Auditors are sometimes requested to perform other services related to fraud detection and prevention, for example, special investigations to determine the extent of a suspected or detected fraud. These other services usually include procedures that extend beyond or are different from the procedures ordinarily performed in an audit of financial statement in accordance with generally accepted auditing standards (GAAS). Chapter 1, “Attest Engagements,” of Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101), and Statement on Standards for Consulting Services (AICPA, *Professional Standards*, vol. 2, CS sec. 100) provide guidance to accountants relating to the performance of such services.

.168 Some of the new elements included in the revised Guide are illustrative control objectives for various types of service organizations as well as three recently issued audit interpretations that address the responsibilities of service organizations and service auditors with respect to forward-looking information and the risk of projecting evaluations of controls to future periods. The Guide also clarifies that the use of a service auditor's report should be restricted to existing customers and is not meant for potential customers.

Help Desk—You can obtain the Guide by contacting the AICPA at (888) 777-7077 and requesting product number 012772kk or by going online at www.cpa2biz.com.

Accounting Pronouncements and Guidance Update

.169 Presented below is a list of recently issued accounting pronouncements and other guidance issued since the publication of last year's Alert. See the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] for a summary explanation of these issuances. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy*.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13 and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated With Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions</i>
SOP 01-5	<i>Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</i>
SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i>

On the Horizon

.170 You should keep abreast of auditing and accounting developments and anticipated guidance that may affect your engagements. In considering exposure drafts toward this end, remember that they are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

FASB Issues EDs Related to Stock-Based Compensation

.171 In October 2002, the FASB issued an exposure draft, *Accounting for Stock-Based Compensation: Transition and Disclosure—an Amendment of FASB Statement No. 123*. The proposed standard would amend the transition and disclosure provisions of FASB No. 123 but would not amend its recognition and measurement provisions. In addition, in November 2002, the FASB issued an exposure draft, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, Accounting for Stock-Based Compensation, and Its Related Interpretations, and IASB Proposed IFRS, Share-based Payment*. For more information about these proposed standards, go to the FASB Web site at www.fasb.org. (See discussion of Stock Options in the previous "Stock Options" section of this Alert.)

AICPA Resource Central

.172 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your e-business engagements (product numbers appear in parentheses).

- AICPA general *Audit Risk Alert* [AAM section 8010]
- Audit Guide *Auditing Revenue in Certain Industries* (012510kk)

- Audit and Accounting Guide *Audit Sampling* (012530kk)
- Audit Guide *Analytical Procedures* (012551kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (010010kk)
- *Accounting Trends & Techniques—2002* (009894kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (006701kk)
- Practice Aid *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries* (006609kk)

Audit and Accounting Manual

.173 The *Audit and Accounting Manual* (product no. 005132kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. The Manual contains numerous practice aids, samples, and illustrations, including audit programs; auditors' reports, checklists, and engagement letters; management representation letters; and confirmation letters.

AICPA reSOURCE: Online Accounting and Auditing Literature

.174 Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, *Audit and Accounting Guides* (more than 20), *Audit Risk Alerts* (more than 15) and *Accounting Trends & Techniques*. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Educational Courses

.175 The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in the e-business environment. Those courses include (product numbers are in parentheses):

- *AICPA's Annual Accounting and Auditing Workshop* (2002-2003 edition) (737082kk, text; 187082kk, video). Whether you are in industry or public practice, this course keeps you current and informed, and shows you how to apply the most recent standards.
- *The AICPA's Guide to Consolidations and Business Combinations* (735125kk). Learn how FASB Statements No. 141 and No. 142 have changed the rules for business combinations and goodwill accounting.
- *E-Commerce: Controls and Audit* (731551kk). Do you want to have a basic, yet comprehensive overview of the world of e-commerce? If so, this is the self-study course for you.
- *Guide to XBRL* (731111kk). XBRL (eXtensible Business Reporting Language) has sweeping implications for CPAs in industry and in public practice. The course begins with a big-picture introduction, then covers the enabling technologies, XBRL itself, and the strategic issues.
- *Auditing in a Paperless Society* (730121kk). Now that paper is slowly diminishing, where do you go? This course will teach you how to develop strategies for auditing around, through, and with a computer.

Online CPE

.176 The AICPA offers an online learning tool titled *AICPA InfoBytes*. An annual fee (\$119 for members and \$319 for nonmembers) offers unlimited access to hundreds of hours of CPE content in one- and two-credit courses. Register today at www.cpa2biz.com/infobytes.

CPE CD-ROM

.177 *The Practitioner's Update* (product no. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

.178 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Technical and Ethics Hotlines

.179 Do you have a complex technical question about GAAP, OCBOA, accounting, auditing, compilation engagements, review engagements, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with their answer. You can reach the Technical Hotline at (888) 777-7077.

.180 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

Conference: The Business of E-Business

.181 Among the many conferences the AICPA offers, there is one that might interest you or your e-business clients: the AICPA/ISACA/MIS Training Institute—The Business of E-Business: Audit, Control, and Accounting in a Dot.Com World, which addresses the latest trends, strategies, and best practices of innovative companies involved in e-business.

.182 For additional information, contact CPA2biz at its Web site, www.cpa2biz.com.

Web Sites¹⁰

AICPA Online and CPA2Biz

.183 AICPA Online, at www.aicpa.org, informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, CPA2Biz, at www.cpa2biz.com, offers you all the latest AICPA products, including more than 15 Audit Risk Alerts, more than 20 Audit and Accounting Guides, the Professional Standards, and CPE courses.

.184 This Audit Risk Alert replaces the *E-Business Industry Developments—2001/02 Audit Risk Alert*. The *E-Business 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 e-mail these comments to Leslye Givarz at lgivarz@aicpa.org, or write to:

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¹⁰ Additional helpful Web sites are presented in Appendix C.

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Appendix A

Identifying and Managing E-Business Risks

Risks in E-Business

Business risk is a term used to describe the risk inherent in a firm's operations. If a firm engages in e-business, its business risk typically changes in nature and increases. This is a result of the risks associated with e-business, such as increased reliance on technology and the fact that this technology changes rapidly. Deloitte and Touche, LLP, has identified common risk-increasing characteristics of firms engaged in e-business.¹ Some of these characteristics include the following:

- Rapid growth
- Mergers and acquisitions
- Formations of new partnerships
- Obtaining financing through debt and equity offerings and/or initial public offerings
- Upgrading and installing new technology
- Taking new products to market
- Complex information systems
- Changes in management
- Regulatory compliance difficulties
- Increasingly complex business models and processes

Any firm's risk management program should be comprehensive enough to encompass the risks stemming from these characteristics. However, effectively managing these risks is an increasingly high priority for e-business firms because they are currently more likely than other firms to exhibit these characteristics.

Remember, e-business is not only the buying and selling of goods and services over the Internet. Any electronic transfer of information that facilitates a company's operations can be termed e-business. Consequently, the risks of e-business are as broad as the term itself. However, the general categories of e-business risk can be summarized as follows:²

- IT infrastructure vulnerabilities
- Falsified identity
- Compromised privacy
- Destructive or malicious code
- System interdependencies

Information Technology Infrastructure Vulnerabilities

One of the primary sources of risk facing e-business firms stems from vulnerability in the organization's IT infrastructure—the hardware, software, and processes that allow day-to-day operations to be carried out. Other risks associated with infrastructure vulnerabilities include the following:

¹ *Enterprise Risk Services*, Deloitte and Touche LLP, 1998.

² Steven M. Glover, Stephen W. Little, and Douglas F. Prawitt. *E-Business Principles and Strategies for Accountants*. Englewood Cliffs, N.J.: Prentice Hall, 2001.

- Denial-of-service attacks, such as the one experienced by Yahoo and others
- Physical outages, such as those caused by hardware failures
- Design failures, such as in February 2000, when the NASDAQ suffered an outage because a problem in a communications feed to one of its mainframe computers froze the NASDAQ Composite Index for two-and-a-half hours
- Operations failures, such as errors or malicious acts by operations personnel
- Environmental outages, such as those caused by natural disasters
- Reconfiguration outages, such as those caused by software upgrades, database maintenance, or hardware changes

Controlling Risks Associated With Infrastructure Vulnerabilities

Companies stand to lose millions of dollars in equipment, software, and sensitive information when a disaster strikes. Enterprises should prepare to minimize the effects of disasters by having a good disaster recovery plan. In addition to a good disaster recovery plan, e-businesses may use software-based security packages as an integral part of controlling the risks associated with infrastructure vulnerabilities. There are several different types of software security packages, including the following:

- *Firewalls.* Software applications designed to block unauthorized access to files, directories, and networks.
- *Intrusion detection software.* Applications that constantly monitor a system and its components and notify users of unauthorized entrance into a system.
- *Scanners or security probes.* Applications that test the strength of security measures by actively probing a network for vulnerabilities. (The SATAN and COPS probes, available for free on the Internet, are examples of general security probes.)

Other ways to protect an organization from the risk associated with infrastructure vulnerabilities include the encryption of information, physical controls, and use of passwords (with periodic password change requirements).

Falsified Identities

Falsified identity is a major source of exposure and risk in conducting e-business. For an electronic transaction to take place, each party to the transaction needs to be confident that the claimed identity of the other party is authentic. These threats are less of a concern in traditional electronic data interchange environments because they involve relatively limited access points, dedicated lines, and established network providers as intermediaries. But authenticity is a significant concern for transactions conducted in an Internet-based environment. The following are examples of risks associated with identification and authenticity:

- *E-mail spoofing.* Hackers can hide their identity simply by changing the information in an e-mail header. In addition, e-mail spoofing can be associated with virus transfers and "spam" mail.
- *IP spoofing.* Some security measures, such as firewalls, may be configured to disallow access to incoming requests with certain IP addresses. By changing the IP address to one that the security system will not block, an unauthorized person can sometimes gain access to the system.
- *Customer impersonation.* Like traditional businesses that accept checks or credit cards, e-businesses face the burden of verifying customer identity. If a consumer has falsified his or her identity, businesses can lose money on fraudulent requests for products or services.
- *False Web sites.* Also called false storefronts, false Web sites are set up to grab confidential information, leading to further misdeeds.

Controlling the Risks Associated With Falsified Identity

The evolution of e-business has caused a shift in the area of identity issues. With the emergence of the Internet as the primary vehicle for e-business, the potential exists for a virtually unlimited number of parties to attempt to initiate transactions. Some of the controls available for authentication and identification in the e-business environment include the following:

- *Digital signatures and certificates.* Just as a signature on a paper document serves as the authentication or certification of a procedure or important information, a digital signature provides beneficiaries assurance that the transaction is valid.
- *Biometrics.* One of the most promising areas of technology and systems security is biometrics, the use of unique features of the human body to create secure access controls. Because each person possesses unique biological characteristics (for example, iris and retina patterns, fingerprints, voice tones, and writing styles), scientists have been able to develop specialized security devices that are highly accurate in authenticating an individual's identity.

Compromised Privacy

Consumers remain concerned that their privacy may be violated if they engage in e-business transactions. Several surveys have found that consumers' biggest concerns are privacy and security. Privacy risks are of concern to e-businesses because (1) consumers who are not confident that their personal information will be kept secure and confident are less likely to transact business with an e-business company and (2) e-businesses that either purposefully or inadvertently share customers' personal information with third parties may be exposed to legal liability and litigation.

Controlling the Risks Associated With Compromised Privacy

E-businesses interested in protecting the privacy of their customers should develop and implement effective privacy policies. Given the fact that many e-businesses are guilty of violating their own privacy policy, e-businesses that are serious about enhancing customers' confidence that their privacy will be preserved sometimes purchase independent third-party assurance services.

Destructive or Malicious Code

Regardless of their origins, harmful codes and programs have the potential to shut down entire networks and cause huge costs in the form of lost sales and productivity. The following table provides an overview of some harmful codes and programs.

Common Destructive Codes and Programs

<i>Type</i>	<i>Characteristics</i>	<i>Example</i>
Virus	This software was designed to replicate itself and spread from location to location without user knowledge. A virus usually attaches itself to a system in such a way that it is activated when a part of the system is activated.	The "Love Bug" virus was designed to attack users of the Microsoft Outlook® mail program.
Worm	Worms are similar to viruses except that worms do not replicate themselves. Worms are created to destroy or change data within a system.	The "Code Red" worm was designed to attack computers using Microsoft's Internet Information Server®.

(continued)

<i>Type</i>	<i>Characteristics</i>	<i>Example</i>
Trojan horse	This malicious program appears to be a legitimate program or file. When the "legitimate" file is activated, the program is activated, detaches itself, and damages the system that activated it.	
Hoax	A file or message is sent out claiming to be a virus but it is really not a virus.	A Valentine's Day hoax read as follows: "Read this immediately . . . on February 14, 2000, you may receive an e-mail that says 'Be My Valentine.' Do not open it . . . it contains a deadly virus . . . it will erase all of your Windows files."
Logic bomb	This code is inserted into an operating system or application that causes a destructive or security-compromising activity whenever certain conditions are met.	The famous Michelangelo virus was embedded in a logic bomb. The virus was triggered on the artist's birthday, March 6.
Trap door	This illegitimate access is created by programmers enabling easy navigation through software programs and data without going through normal security procedures.	Trap doors are sometimes very useful in systems development, but programmers sometimes fail to close trap doors on completion of a project.
Cross-site scripting	Malicious code is embedded on Web pages with tiny "scripting" programs that make sites more interactive. An unsuspecting Web site visitor then activates the hacker's program by using the corrupted scripting program.	In August, a hacker used cross-site scripting to wipe out desktop icons of Web users visiting Price Lotto, a Japanese auction site.

System Interdependencies

System interdependencies expose e-businesses to risks that come from outside traditional organizational boundaries. E-business often involves highly interdependent relationships with customers, suppliers, and various service providers. These partnerships are vital, but the interdependent nature of these partnerships means that the risks an enterprise faces are at least partly determined by how well partners identify and mitigate the risks to their systems.

Because the quality of a partnership depends heavily on the quality of each partner's information systems, as well as on the communication system between partners, organizations must ensure that their information systems are well managed and controlled. In addition, an e-business must also ensure that the information systems of its critical partners allow for the safe acquisition, processing, storage, and communication of important information. Thus, in an e-business environment, organizations must realize their responsibility to ensure that their trading partners are using effective risk identification and management processes to protect the strength and integrity of the entire network of interdependent enterprises.

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Appendix B

Trust Assurance Services

During the past five years, the AICPA and Canadian Institute of Chartered Accountants (CICA) introduced Principles and Criteria to address concerns in the marketplace for assurance around systems reliability and e-commerce activities. These were specifically applicable to two AICPA/CICA assurance services: SysTrust and WebTrust. Although these two initial Principles and Criteria frameworks were very similar, there were a number of differences relating to structure and style. As well, in some cases, the two sets of Principles and Criteria targeted the same basic business concerns (for example, both services provided assurance around security and availability).

After assessing the objectives of SysTrust and WebTrust, the AICPA and CICA decided that the next step in the evolution was to harmonize the underlying Principles and Criteria where commonalities existed and to conform the presentation and wording of the material. To facilitate this change, the separate SysTrust and WebTrust Task Forces were merged to form the Trust Services Task Force. Its first objective was to harmonize the Principles and Criteria and to conform the wording and structure. It was not the goal or intent to change the SysTrust or WebTrust services, or to introduce additional branded services as part of this first task.

The AICPA's Assurance Services Executive Committee and the CICA's Assurance Service Development Board have developed a framework for the development of new services. This framework recognizes that there is a need and an opportunity to build a broad range of professional services in diverse areas. Consequently, the task force issued an exposure draft to accomplish this harmonization.

Due to its unique nature and specific requirements, the Principles and Criteria for WebTrust for Certification Authorities continues as a stand-alone program and is not included as part of this harmonization.

What Are the Significant Changes?

The WebTrust and SysTrust products/services remain unchanged as examination level (audit) assurance services. WebTrust continues to enable assurance on electronic commerce systems. SysTrust continues to enable assurance on any system. As noted above, agreed-upon procedure engagements can be performed using the Trust Services Principles and Criteria that would not result in the issuance of a WebTrust/SysTrust seal/logo.

The task force believes that there has been no substantive change in the scope of work necessary to perform WebTrust or SysTrust engagements. There has been a significant change, however, in the structure, order and wording of the prior Principles and Criteria to achieve the harmonization required.

The following highlights the key changes made as a result of the harmonization of the Principles and Criteria that underscored SysTrust and WebTrust.

Common Set of Principles and Criteria

The SysTrust and WebTrust Principles and Criteria have been harmonized to create a common set of Principles and Criteria, now labeled as the Trust Services Principles and Criteria. No principles have been added. In fact, the criteria for the Principle of Maintainability that existed in the SysTrust Principles have been subsumed under the other principles in the appropriate sections. Therefore, the proposed harmonized set of Principles consists of Security, Availability, Processing Integrity, Online Privacy, and Confidentiality.

Separation of the Measurement Criteria From the Specific Services

The Principles and Criteria have been separated from the specific products and services (that is, SysTrust and WebTrust). Previously they were embedded in the respective service. This separation creates the opportunity

to develop additional branded products and services based on the measurement criteria. The Trust Services Principles and Criteria are considered suitable criteria as defined by professional literature.

Minimum Initial Reporting Period

Previously, under the SysTrust program, there was no defined initial reporting period. In WebTrust 3.0, a minimum reporting period of two months was recommended. This two-month minimum requirement is now applicable to SysTrust engagements.

Controls Reporting Illustrated

Under the WebTrust 3.0 model, the practitioner's report covered management's assertion that an entity disclosed its practices for electronic commerce transactions, complied with such practices, and maintained effective controls. Under SysTrust 2.0, the practitioner's report covered management's assertion that they maintained effective controls. While the examples provided in the exposure draft illustrate the use of reporting on controls only, the Task Force continues to consider the appropriateness of both models. The final release is expected to embrace the original reporting models described for WebTrust 3.0 and SysTrust 2.0.

No Cumulative Reporting

Under WebTrust 3.0, cumulative reporting was an option. Under the new reporting guidelines, it is no longer available. Additional conforming changes have been made to reflect that the services offered are based on a common set of Principles and Criteria.

Consistent Seal Process For Trust Services

WebTrust 3.0 was designed to incorporate a seal management process whereby the WebTrust seal could be used as an electronic representation of the practitioner's unqualified WebTrust report. In contrast, SysTrust did not incorporate the concept of a seal. The SysTrust logo was primarily meant to be used as a symbol for marketing purposes. Under the revised services, the WebTrust service continues to include a seal management process. Now, however, the SysTrust logo may also be used as an equivalent to a seal when the report is presented electronically, provided the issuance of the SysTrust logo as a seal follows the same procedures required to issue a WebTrust seal. Seal management procedures will be provided in the Trust Services publication to be released after the exposure period.

Periodic Examinations

The existing WebTrust service requires updates at least every six months—more frequently if needed based on changes to the e-commerce system. The existing SysTrust service does not have an update requirement. Under the new Trust Services framework, if a report is represented by a seal/logo, updates will be required at least every 12 months—more frequently if circumstances warrant it, regardless of the service. This change reflects the maturity and stability in e-commerce systems and establishes a common standard for the seal or logo.

Licensing

There were separate licensing agreements for SysTrust and WebTrust required with significantly varying requirements. The licensing of the WebTrust Services and SysTrust Services is currently being revised.

Why Change?

The Assurance Services Executive Committee and Assurance Service Development Board concluded, based on recommendations from a working group from the SysTrust and WebTrust Task Forces, that:

- There is no conceptual difference in the respective SysTrust and WebTrust Principles and Criteria taken as a whole.

- While WebTrust was the first service developed, it is, in effect, a specific application of the SysTrust framework.
- There is marketplace confusion among key stakeholders about the differences between the two services.
- There is a need to build a framework of principles and criteria that would be more flexible in meeting the needs of stakeholders in the area of e-commerce and information systems.

For these reasons, the separate SysTrust and WebTrust Task Forces were combined into the Trust Services Task Force. Its first objective was to develop the harmonized Trust Services Principles and Criteria.

Trust Services Principles and Criteria

The following principles have been developed by the AICPA and CICA for use by practitioners in the delivery of Trust Services engagements such as WebTrust and SysTrust. In the course of completing a Trust Services engagement, the practitioner uses the identified Criteria as the basis for assessing whether the particular Principle has been achieved. These principle and criteria definitions have been updated based on the expected release of the Trust Services Principles and Criteria.

Principles

- **Security.** The system¹ is protected against unauthorized access (both physical and logical).
- **Availability.** The system is available for operation and use as committed or agreed.
- **Processing Integrity.** System processing is complete, accurate, timely, and authorized.
- **Online Privacy.** Private information² obtained as a result of electronic commerce is collected, used, disclosed and retained as committed or agreed.
- **Confidentiality.** Information designated as confidential is protected as committed or agreed.

Criteria³

The Criteria associated with each of the Trust Services Principles are organized using a framework covering the following four broad categories:

- **Policies.** The entity has defined and documented its policies⁴ relevant to the particular principle.
- **Communications.** The entity has communicated its defined policies to authorized users.
- **Procedures.** The entity uses procedures to achieve its objectives in accordance with its defined policies.
- **Monitoring.** The entity monitors the system and takes action to maintain compliance with its defined policies.

¹ A "system" consists of five key components organized to achieve a specified objective. The components are categorized as follows: infrastructure (facilities, equipment, and networks), software (systems, applications, and utilities), people (developers, operators, users, and managers), procedures (automated and manual), and data (transaction streams, files, databases, and tables).

² The term *private information* includes personally identifiable information and other sensitive information for which the entity has legal or other privacy obligations and commitments.

³ These criteria meet the definition of "criteria established by a recognized body" described in the third general standard for attestation engagements in the United States (AICPA, *Professional Standards*, vol. 1, AT sec. 100.14) and in the standards for assurance engagements in Canada (CICA Handbook, paragraph 5025.41).

⁴ The term *policies* refers to written statements that communicate management's intent, objectives, requirements, responsibilities and/or standards for a particular subject. Some policies may be explicitly described as such, being contained in policy manuals or similarly labeled documents. However, some policies may be contained in documents without such explicit labeling, including for example, notices or reports to employees or outside parties.

The Criteria have been specifically designed to facilitate engagements related to a single Principle, or combinations of Principles to meet the client's particular needs. Where an engagement involves more than one Principle, there may be significant areas of overlap in the Criteria. In such circumstances the practitioner must be satisfied that the criteria have been achieved for each Principle, but may not need to duplicate the effort required to accomplish this.

Help Desk—For more detailed information on Trust Assurance services, go to the AICPA Assurance Services Web site at www.aicpa.org/assurance/index.htm.

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Appendix C

The Internet—An Auditor's Research Tool

The following table gives Web sites that you may find useful to your practice.

<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	www.aicpa.org
Financial Accounting Standards Board	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
Governmental Accounting Standards Board	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
Securities and Exchange Commission	SEC Digest and Statements, EDGAR database, current SEC rulemaking	www.sec.gov
FASAB	Federal Accounting Standards Board	www.fasab.gov
U.S. Federal Government Agencies Directory	A list of all federal agencies on the Internet	www.lib.lsu.edu/gov/fedgov.html
The Electronic Accountant	World Wide Web magazine that features up-to-the-minute news for accountants	www.electronicaccountant.com
CPAnet	Online community and resource center	www.cpalinks.com/
Accountant's Home Page	Resources for accountants and financial and business professionals	www.computercpa.com/
U.S. Tax Code Online	A complete text of the U.S. Tax Code	www.fourmilab.ch/ustax/ustax.html
Federal Reserve Bank of New York	Key interest rates	www.ny.frb.org/pihome/statistics/dlyrates
FirstGov	Portal through which all government agencies can be accessed	www.firstgov.gov
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
International Federation of Accountants	Information on standards-setting activities in the international arena	www.ifac.org

(continued)

<i>Name of Site</i>	<i>Content</i>	<i>Internet Address</i>
Hoovers Online	Online information on various companies and industries	www.hoovers.com
Ask Jeeves	Search engine that utilizes a user-friendly question format and provides simultaneous search results from other search engines as well (for example, Excite, Yahoo, and AltaVista)	www.askjeeves.com

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AAM Section 8220

Single Audits—2003

NOTICE TO READERS

We, as members of the AICPA staff, have developed this Audit Risk Alert to provide you, as an auditor of organizations receiving federal awards, with an overview of recent industry, regulatory, and professional developments that may affect the audits you perform. This document presents brief summaries of recently issued auditing pronouncements, legal and regulatory provisions, and other guidance. We present those summaries for your information only; you should not rely on them as a substitute for a complete reading of the source material. This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150), as amended. Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an *Other Auditing Publication*, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Industry Developments

.01 This Audit Risk Alert assumes that you have some basic knowledge about single audits performed under the Single Audit Act Amendments of 1996 (the Single Audit Act) (Public Law [P.L.]104-156) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133). If it has been a while since you have performed a single audit or you are new to the area, Appendix A, "Overview of Key Components of a Single Audit," includes an overview of various key components of a single audit that should be of use to you. You should also refer to the AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (Single Audit Guide), for more comprehensive guidance.

.02 Things continue to percolate in the area of single audits. New independence rules issued by the U.S. General Accounting Office (GAO) through its *Government Auditing Standards* (GAS—also known as the Yellow Book—terms that are used interchangeably in this Alert) have become effective for the first time. Further, the GAO has recently issued a complete overhaul to *Government Auditing Standards* that will become effective in 2004. There have also been several pieces of new regulation and other guidance issued during the past year that will affect your single audits. First, the OMB revised Circular A-133 in June 2003 to, among other things, increase the threshold for performing single audits. This revision is not effective until fiscal years ending after December 31, 2003, and early implementation is *not* permitted. Second, the 2003 version of the Circular A-133 *Compliance Supplement* (the Supplement) was issued in March 2003. The OMB has also issued proposed revisions to the various OMB cost circulars. Improvements to the grants management process are also in the works because OMB recently issued several final rules and proposals to carry out that objective. Most of these grants management initiatives will affect primarily your auditees (for example, by requiring them to identify themselves via a unique identifying number).

.03 Audit quality continues to be an area of utmost importance. Both the AICPA peer review and disciplinary processes continue to indicate that there are problems in the single audits they are reviewing.

Federal Offices of Inspectors General (OIGs) have found problems based on their reviews of single audit work that are consistent with those found by the AICPA. As a result, the OIGs are working to coordinate a national statistical sample of single audit work to be reviewed. Their objective in performing these reviews is to be able to identify how extensive the single audit quality problems may be. You should keep these quality concerns in mind as you prepare for and perform your single audits this year. For example, you should be sure that you and your staff are fully aware of the various complex requirements for a single audit and that all staff are current on their educational requirements. If not, perhaps a refresher educational course or two is a good idea. Further, you should be sure that all members of the engagement team have access to and familiarity with the many forms of single audit guidance that are available. For example, be sure that your team has the most current Single Audit Guide, Yellow Book, and the Supplement. You should also consider asking key staff members to read this Alert before performing their single audits.

.04 The following sections of this Alert cover many of these items in more detail.

Regulatory, Legislative, and Other Developments

OMB Raises Single Audit Threshold and Revises Other Sections of Circular A-133

.05 In the June 27, 2003, *Federal Register* (68 FR 38401) the OMB issued a revision to Circular A-133 that raises the threshold that triggers a single audit. Other revisions include a change to the threshold that determines whether an auditee is assigned a cognizant agency for audit versus an oversight agency for audit and related technical changes to facilitate that determination and to provide for federal agency reassignment of the oversight agency for audit.

.06 *Single audit threshold.* The Single Audit Act provides for the OMB director to review the single audit threshold every two years and increase it as appropriate. The new audit threshold requires all grantees that expend \$500,000 or more a year in federal awards to have an audit conducted in accordance with Circular A-133 (the former audit threshold amount was \$300,000). This increase will relieve approximately 6,000 entities from the audit requirements of Circular A-133 while retaining audit coverage for 99.5 percent of federal awards currently audited (in dollars). This change is effective for fiscal years ending after December 31, 2003, and early implementation is *not* permitted.

.07 *Cognizant agency threshold.* For auditees expending greater than \$25 million a year in federal awards, the cognizant agency for audit is the federal awarding agency that provides the predominant amount of direct funding to the auditee (unless the OMB makes a specific cognizant agency for audit assignment). An auditee that does not have a designated cognizant agency for audit has an oversight agency for audit. Paragraphs 2.29 through 2.32 of the Single Audit Guide describe the differences between the cognizant and oversight agency for audit in greater detail. The revision increases the cognizant agency for audit threshold from \$25 million to \$50 million. This will reduce the number of auditees assigned a cognizant agency for audit from approximately 1,000 to approximately 500. This change is effective for fiscal years ending after December 31, 2003, and early implementation is *not* permitted.

.08 *Other technical changes.* The revisions also contained two technical changes. First, Circular A-133 definitions have not specifically provided for the reassignment of oversight agency for audit. The revisions explicitly allow the reassignment of the oversight agency for audit by federal agencies similar to the provision in Circular A-133 that allows for the reassignment of the cognizant agency for audit. This provision is effective July 28, 2003. Second, the revisions make 2004 the base year for determining the cognizant agency for audit for 2006 through 2010. All fiscal year 2004 Circular A-133 reports are due to the Federal Audit Clearinghouse (FAC) on or before September 30, 2005. This will provide sufficient time for federal agencies to use the FAC database to produce a cognizant agency for audit listing for the 2006 through 2010 audit cognizance period at the start of 2006. You should note that the base year for 2001 through 2005 will remain at 2000.

Federal Grant Streamlining Program

.09 Work continues on the implementation of the Federal Financial Assistance Management Improvement Act of 1999 (P.L. 106-107). The purposes of P.L. 106-107 are to (1) improve the effectiveness and performance of federal financial assistance programs, (2) simplify federal financial assistance application and reporting requirements, (3) improve the delivery of services to the public, and (4) facilitate greater coordination among those responsible for delivering the services. Under joint leadership from the OMB and the Department of Health and Human Services, agencies are working together to make it easier for state, local, and tribal governments; universities; and not-for-profit organizations to administer federal grant programs. In addition to the final notice issued June 27, 2003, regarding Circular A-133 revisions (see the previous section of this Alert titled “OMB Raises Single Audit Threshold and Revises Other Sections of Circular A-133”), the OMB has issued other final notices and various proposals during the past year related to these efforts, and a brief description of each follows:

- A June 27, 2003, *Federal Register* (68 FR 38402) notice of final policy, titled *Use of a Universal Identifier by Grant Applicants*, establishes a standard means for tracking federal grant recipients throughout the entire grant life cycle. The notice requires each applicant to be uniquely identified and to register for a Dun and Bradstreet (D&B) Data Universal Numbering System (DUNS) number for use as the Universal Identifier needed to respond to federal agency grant or cooperative agreement announcements. The number must be provided for both paper and electronic applications submitted on or after October 1, 2003.
- A June 23, 2003, *Federal Register* (68 FR 37370) notice of final policy directive, titled *Office of Federal Financial Management Policy Directive on Financial Assistance Program Announcements*, establishes a standard format for federal agency announcements of funding opportunities under programs that award discretionary grants or cooperative agreements.
- A June 23, 2003, *Federal Register* (68 FR 37379) notice, titled *Standard Data Elements for Electronically Posting Synopses of Federal Agencies' Financial Assistance Program Announcements at Grants.gov FIND*, establishes the government-wide standard data elements for federal agency use in electronically posting synopses of discretionary grant and cooperative agreement funding opportunities.
- A June 23, 2003, *Federal Register* (68 FR 37385) notice of proposed policy guidance, titled *Government-Wide Guidance for Use of Grants.gov FIND To Post Funding Opportunity Announcement Synopses*, would require federal agencies to electronically post synopses of funding opportunities under federal financial assistance programs that award discretionary grants and cooperative agreements at www.FedGrants.gov.
- A June 6, 2003, *Federal Register* (68 FR 33883) proposal, titled *Government-Wide Guidance for Grants and Agreements*, would publish in a single title in the Code of Federal Regulations (CFR), OMB's guidance to federal agencies for grants and agreements (currently the guidance is located in seven separate OMB Circulars and other policy documents). This proposal would also create in the same new title of the CFR a subtitle in which federal agencies will collocate their regulations for the award and administration of grants and agreements.
- An April 8, 2003, *Federal Register* (68 FR 17090) proposal, titled *Standard Data Elements for Federal Grant Applications*, would, among other things, establish a standard set of data elements and definitions for federal agencies and grant applicants to use on both paper and electronic applications for discretionary grants.
- An August 12, 2002, *Federal Register* (67 FR 52558) proposal, titled *Cost Principles for Educational Institutions, for State, Local, and Indian Tribal Governments and for Non-Profit Organizations*, would revise three OMB Circulars (A-21, *Cost Principles for Educational Institutions*; A-87, *Cost Principles for State, Local and Indian Tribal Governments*; and A-122, *Cost Principles for Non-Profit Organizations*), to clarify ambiguous language. The three cost principle circulars apply to different types of recipient organizations and were developed separately. Consequently, different language is used in the three circulars

to describe similar cost items, sometimes causing inconsistent interpretations by federal staff, recipients, and auditors. The OMB is not intending to change the policy in any of the circulars.

- An August 12, 2002, *Federal Register* (67 FR 52547) notice, titled *Circular A-110, "Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations,"* describes OMB's decision not to revise OMB Circular A-110 to require that federal agencies offer grantees the option to request cash advances on a pooled basis.

.10 The proposal related to clarifying language in the three cost principles circulars (A-21, A-87, and A-122) is the most likely to have an implication on the single audit work that you do. A final rule is expected in the fall of 2003. Although the remaining notices and proposals included in the bulleted list above primarily affect your auditees as they go through the grant application process, brief descriptions have been included here because your auditees may ask for your assistance in helping them understand the many changes that are underway.

Help Desk—Check the "Current Document" section of the OMB Web site (www.omb.gov/grants) for updates on the status of the various proposals described in this section, as well as any new proposals that are issued.

Help America Vote Act

.11 In October, 2002, the Help America Vote Act (P.L. 107-252) was passed. The Act provides funds to states to, among other things, replace punch card voting systems; educate voters; and train election officials, poll workers, and election volunteers. Funds will be distributed to states that may in turn pass the funds through to local governments. Based on questions that were received, the OMB recently determined that the funds distributed under the Help America Vote Act are subject to the Single Audit Act. The General Services Administration recently assigned a *Catalog of Federal Domestic Assistance* (CFDA) number, 39.011, to its portion of the program. Over the next few months, the OMB will consider whether this program will be added to the 2004 update to the Supplement.

Help Desk—If your auditees receive funds under this program, you can advise them to check the CFDA on the Internet at www.cfda.gov/public/cat-whatshere.htm to obtain more information about the program. As the program itself is not in the 2003 Supplement, you should refer to the law, the CFDA, and Part 7 of the Supplement to determine the compliance requirements you should be concerned with if you have to audit this program as a major program. The law can be accessed at the Thomas legislative search Web site at frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_public_laws&docid=f:publ252.107.pdf or via the Federal Election Commission's Web site at www.fec.gov/hava/hava.htm.

Health Insurance Portability and Accountability Act

.12 If you have visited your doctor's office recently, you have probably been introduced to some aspect of the Health Insurance Portability and Accountability Act of 1996 (HIPAA). Effective April 14, 2003, it is probably the single most significant piece of federal legislation affecting the health care industry since the inception of the Medicare and Medicaid programs. While HIPAA has many facets, one of the key focuses is on the privacy of individually identifiable health information. While there are many HIPAA implications that affect you personally, there may also be implications for you if you perform single audits of health care entities (referred to as covered entities under the Act) subject to HIPAA. For example, if you are performing a single audit that involves the review of personal medical information, you are likely considered a "business associate" under HIPAA. A business associate is a person or entity who provides certain functions, activities, or services for or to a covered entity, involving the use and/or disclosure of protected health information (PHI). In allowing covered entities to provide PHI to business associates, HIPAA also requires those entities to get certain assurances from the business associates. Your firm or audit organization may have already been asked to sign a business associate agreement that asks you to agree, for example, that you will use the

PHI only for the purposes for which you were engaged and that you will safeguard the information from misuse. Before signing such an agreement, you may want to consult with your legal counsel and also ensure that you have established policies and procedures to allow your firm or organization to comply with the specific documentation requirements of the agreement, safeguarding of PHI, and monitoring the release of PHI when necessary.

Department of Education's eZ-Audit

.13 Under Circular A-133, not-for-profit and public institutions must submit their annual audits to the Federal Audit Clearinghouse (FAC), which in turn provides copies to the U.S. Department of Education (ED). In the May 16, 2003, *Federal Register* (68 FR 26586), the ED issued a notice implementing a new electronic process (eZ-Audit) for submitting compliance and financial statement audits. Beginning on June 16, 2003, institutions that participate, or seek to participate, in the federal student financial aid programs must submit their Circular A-133 audits directly to the ED through eZ-Audit. In addition to filing the compliance and financial audit in the form of a noneditable electronic PDF file, your auditees will also have to submit compliance audit data and summary financial data via an Internet Web form. You should note that this new electronic submission process does not alleviate the normal FAC submission requirements of Circular A-133. There is no required auditor association with the new electronic submission requirements. However, you may be asked to provide your auditees that are subject to the new eZ-Audit rules with an electronic version of your auditor's reports. Further, your auditees may engage you to assist them with the data entry of the information.

Help Desk—The ED has developed step-by-step guides for both not-for-profit and public institutions that contain an overview of the new process, information on how to register and obtain identification numbers and passwords, as well as other administrative and security procedures. You can find these guides on the ED Web site at <http://ifap.ed.gov/eannouncements/0328GuideUsingZAudit.html>.

Adherence to Professional Standards and Requirements

Auditor's Ethical Obligations to Follow Standards or Guidelines

.14 Be aware that AICPA Ethics Interpretation No. 501-3, "Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits," of *Acts Discreditable* (AICPA, *Professional Standards*, vol. 2, ET sec. 501.04), states that when an auditor undertakes an audit of government grants or recipients of government monies and agrees to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, he or she is obligated to follow these standards or guidelines in addition to generally accepted auditing standards (GAAS). Failure to do so discredits the profession and violates rule 501 of the AICPA Code of Professional Conduct, unless it is disclosed in the auditor's report that these rules were not followed and the reasons for doing so are given.

Results of AICPA Peer Reviews and Ethics Investigations

.15 Both the AICPA Peer Review Program and ethics investigations continue to indicate that there are problems in some of the single audits they are reviewing. Many are consistent with those reported in last year's Alert and include problems with the application of the risk-based approach to selecting major programs for testing, documentation issues, and noncompliance with various auditing standards and other requirements. Further, many are consistent with the findings of the federal OIGs (see the following section of this Alert titled "Federal OIG Quality Control Reviews"). A more complete description of deficiencies commonly noted on single audits during recent peer reviews and AICPA Professional Ethics Division investigations of CPA firms, as well as quality control reviews performed by federal OIGs, is included in Appendix B, "Common Engagement Deficiencies Noted in Peer Reviews, Ethics Investigations, and Federal OIG Quality Control Reviews," of this Alert.

Federal OIG Quality Control Reviews

.16 During the past year, federal OIGs continued performing quality control reviews (QCRs) at a brisk pace. The OIGs continue to note audit problems that include auditors' internal control and/or compliance testing and compliance with *Government Auditing Standards*. In order to provide an overall assessment of single audit quality, an interagency, interdisciplinary task force to be led by the U.S. Department of Education has been established. That task force will oversee a statistical sampling of single audits and the review of those audits selected. As of the date of this Alert, the task force is in its initial strategy phase, which includes looking at the methodology that might be used in selecting the statistical sample and how the reviews will be carried out. It is planned that 50 percent to 60 percent of the reviews of selected audits will be conducted by practitioners under contract by the federal government. However, the conduct of this project is subject to the approval of funding (it was included the president's proposed budget for federal fiscal year 2004). If this funding is approved on a timely basis, it is anticipated that the sample of audits will be selected during the latter part of 2003 and early 2004, with the actual reviews commencing in spring 2004. Once the reviews are completed, the task force will be drawing conclusions about the overall quality of single audit work performed based on the statistical sample of audits reviewed.

.17 A more complete description of deficiencies found by both federal OIGs and the AICPA is included in Appendix B, "Common Engagement Deficiencies Noted in Peer Reviews, Ethics Investigations, and Federal OIG Quality Control Reviews," of this Alert.

.18 Also, the FAC has recently prepared a report using its database of submitted single audits to highlight potential audit problems. As noted in Appendix B, one of the most common problems the AICPA and OIGs have found is that auditors have not been appropriately applying Circular A-133's "two-year lookback" rule (that is, a type A program should be audited as a major program in the current year if it has not been audited in at least one of the two most recent audit periods). Using an electronic means, the FAC has identified audits where it appears that a type A program should have been audited as a major program (because it was not audited as major in one of the previous two years) and has passed this information to the various OIGs affected for their follow-up.

Help Desk—The President's Council on Integrity and Efficiency (PCIE) has issued the *Uniform Guide for Initial Review of A-133 Audit Reports and the Uniform Quality Control Review Guide* for use by OIGs when performing desk reviews and quality control reviews. Both are available electronically on the Internet at www.ignet.gov/pande/audit/psingle.html. Before completing your Circular A-133 audits, consider reviewing the guides to gain an understanding of what the OIGs will be looking for in their reviews. Taking this step will help ensure that your engagements meet the criteria identified. You can also refer to chapter 3 of the Single Audit Guide for further discussion of the desk review and QCR processes.

Circular A-133 Audit Guidance Update

2003 Compliance Supplement Issued

.19 The OMB issued its 2003 Supplement in March. The 2003 Supplement includes information to help you understand the objectives, procedures, and compliance requirements of 160 federal programs. Part 7 of the Supplement, "Guidance for Auditing Programs Not Included in This Compliance Supplement," provides guidance to help you determine relevant compliance requirements, audit objectives, and suggested audit procedures for programs not included in the Supplement. Although the primary focus of the work on the 2003 Supplement was to update previously included federal programs, it does add four programs. The 2003 Supplement is effective for audits of fiscal years beginning after June 30, 2002, and supersedes the previous Supplement, which was issued in March 2002.

.20 Appendix V of the Supplement lists changes from the 2002 Supplement. Among the more significant changes, the 2003 Supplement includes the following:

- In Part 3, “Compliance Requirements,” the section titled “Allowable Costs Cost Principles” has been substantially rewritten to reflect a reorganization by individual cost principles circular (A-21, A-87, A-122). The section begins with general guidance on allowable costs, followed by specific compliance guidance for each of the three cost principles circulars. Further, there was a substantial rewrite of Exhibits 1 and 2 to combine them as a single exhibit, titled “Exhibit 1, Selected Items of Costs.” Twenty-seven selected items of costs were added to the new Exhibit 1.
- In the section titled “Eligibility,” in Part 3, the audit responsibility has been clarified when there are split eligibility determination functions. It also clarifies that required redeterminations of eligibility should be tested.
- In the section titled “Subrecipient Monitoring,” in Part 3, there has been a substantial rewrite to clarify compliance requirements, during-the-award monitoring, and suggested audit procedures.
- In Part 4, “Agency Program Requirements,” and Part 5, “Clusters of Programs,” there are revisions to the program requirements for many existing programs and program clusters for the effect of new laws and regulations or for other reasons.
- In Part 4, the section titled “Department of Education Cross-Cutting” and various education programs were updated for changes made by the No Child Left Behind Act of 2001 (P.L. 107-110).

Help Desk—You may purchase the 2003 Supplement from the Government Printing Office or download a free electronic copy from the OMB Web site, as discussed in the section of this Alert titled “References for Additional Guidance.” Further, the CFDA numbers for federal programs often change. You can obtain information about number changes in the CFDA’s list of current-year changes and in its Appendix VII, “Historical Profile of Catalog Programs,” which lists changes since 1965. The table of contents for the CFDA, which can take you to all sections of the CFDA, is on the Internet at www.cfda.gov/public/cats-whatshere.htm.

Data Collection Form Update

.21 The FAC collects information about Circular A-133 audits on a data collection form for entry into a database that is accessible through its Web site. You should be sure that you are using the appropriate version of the form. The OMB issued a revised form and accompanying instructions to report the results of Circular A-133 audits for fiscal periods ending on or after January 1, 2001. Audits covering fiscal period end dates before January 1, 2001, should continue to use the previous version of the data collection form (dated August 1997). Both versions of the form are available on the FAC Web site. You should also be aware that the FAC encourages you to complete your submission online via the FAC’s Internet data entry system (IDES). Even though you still have to submit a signed and dated hard copy of the form, the IDES runs your submission through an online edit check that increases the likelihood that your form will be accepted without errors. Currently the FAC is receiving approximately 70 percent of data collection forms through the IDES.

.22 Even with the online edit process, the FAC is still finding a few common errors in the forms that are submitted. A description of those problem areas follows.

.23 *Signing and dating the form.* The most common error that the FAC has noted is that the form is submitted without one or both of the signatures that are required (the auditor and auditee both must sign) or it is not dated. For the FAC to accept the form, it must have the appropriate signatures and date on it. You should remind your auditee to check this before submitting the hard copy form with the reporting package.

.24 *Federal program detail.* Certain details applicable to the federal programs identified on page 3 of the form are either missing or incorrect. The areas where problems have been noted include invalid CFDA prefixes are being entered, the research and development box either is left blank or two conflicting boxes are

checked, the box for types of compliance requirements either is left blank or an invalid type code is entered, and the finding reference number field is often left blank. You should take care to ensure that federal program information is filled in completely, is correct, and that it matches other information in the reporting package.

.25 Number of reporting packages to be submitted. The purpose of Part III, Item 9, of the form is to determine which federal agencies are required to receive the reporting package. The FAC is finding that some auditors are either not checking off all of the agencies that should be identified in this section or are entering an invalid agency. You should be sure that you identify all federal agencies that have current-year audit findings related to direct funding or prior audit findings (identified in the Summary Schedule of Prior Audit Findings) related to direct funding in this question. It is also important that the answer to this question be consistent with Part III, Item 10(f), of the form, which asks that direct awards be identified.

.26 Mathematical mistakes. The FAC has found that when it recalculates the total of the lines in Part III, Item 10(d), of the form under the column heading "Amount Expended," that total sometimes does match the total federal awards expended entered at the bottom of that column. You should recheck your math before submitting the form.

.27 Questions either left blank or multiple boxes checked. Part III, Items 2, 5, and 7, all require a "yes" or "no" answer. The FAC has found that some auditors are either checking both boxes, or leaving the entire question blank. Each question on the form must be completed with one answer for the FAC to accept the form.

.28 Form submitted separately from reporting package. The FAC periodically receives the reporting packages separate from the hard copy data collection form. While this is not technically a form error, it does delay the overall completion of the submission because the FAC needs both the form and the reporting package so certain information in the form can be verified against the package. The FAC encourages that the data collection form be submitted with the reporting packages in all cases.

.29 Finally, you should note that every three years, the OMB is charged with reviewing the form and updating it for any changes that are necessary. The current form was revised in 2001. The process is now underway for new form revisions, and you should expect to see a proposed revision to the form in the *Federal Register*, asking for your comments, sometime this summer. Next year's Alert will advise you of any changes that are made to the form.

Help Desk—You can complete and submit the data collection forms electronically at the FAC Web site at harvester.census.gov/sac. The data collection forms and related instructions also are available in portable document format (PDF) versions at the FAC Web site. You can obtain printed copies from the FAC by calling (888) 222-9907. When ordering printed copies by phone, note that the form number is SF-SAC and that you must indicate whether you need the current or previous form. You and the entities you audit are not permitted to create your own version of the forms.

Orange Book: Cognizant Agency Responsibilities

.30 Last issued in 1985, the *Federal Cognizant Agency Audit Organization Guidelines*, also known as the Orange Book, sets forth the responsibilities of the cognizant agencies for audit. It addresses areas such as technical advice and liaison, desk reviews of audit reports, reviews of audit organizations and their work, resolution of deficiencies noted during reviews, and processing audit reports. We reported in last year's Alert that the PCIE was expected to issue a revision to the Orange Book in late 2002. Since then, the issuance of the revision was postponed and is now expected to be issued sometime during the next year. When issued, the revision is expected to consider, among other things, the effects of the Single Audit Act Amendments of 1996 and Circular A-133. The revision also is expected to provide guidance to oversight agencies for audit as well as to the cognizant agencies.

Help Desk—When issued, the Orange Book should be available on IGnet, the Inspectors General's Web site, at www.ignet.gov. Consider reviewing the Orange Book to gain an understanding of the processes used by the Inspectors General and how they could affect your engagements.

Audit and Attestation Issues and Developments

Government Auditing Standards Developments

.31 Circular A-133 requires auditors to follow *Government Auditing Standards* (in addition to GAAS) when performing the financial statement audit portion of a single audit. For this reason, you should be aware of a number of recent revisions that have been made to *Government Auditing Standards*.

Independence

.32 In a GAAS audit, auditors must comply with the AICPA's independence rules included in the AICPA Code of Professional Conduct. For audits performed under *Government Auditing Standards*, auditors and audit organizations are subject to additional independence rules that are in some cases very similar to the AICPA independence rules and in other cases are more restrictive. Amendment No. 3, *Independence*, to *Government Auditing Standards* establishes the additional independence rules under *Government Auditing Standards*. The GAO also has issued a question and answer document titled *Answers to Independence Standard Questions*, which responds to questions related to the independence standard's implementation time frame, underlying concepts, and application in specific nonaudit circumstances. Amendment No. 3, as affected by *Government Auditing Standards: Answers to Independence Questions*, revises the independence standards in *Government Auditing Standards* for audits for periods beginning on or after January 1, 2003, with early implementation encouraged. The independence rules in *Government Auditing Standards* address when auditors and their organizations are independent from the organizations they audit by defining when personal, external, and organizational impairments to independence exist. If an audit organization is not independent, *Government Auditing Standards* states that the auditor should (1) decline to perform the work or (2) report the impairment in the scope section of the auditor's report when a government auditor cannot decline to perform the work because of a legislative requirement or for other reasons.

.33 *Government Auditing Standards* adopts an engagement-team focused approach to independence for matters such as financial interests of an individual auditor, not unlike the AICPA's Code of Professional Conduct. It also provides criteria for when governmental audit organizations are organizationally independent from the audited entity for purposes of external and internal reporting. *Government Auditing Standards* employs a principles-based approach to independence supplemented with certain safeguards for matters such as the performance of nonaudit services. With respect to nonaudit services, the *Government Auditing Standards* rules are generally more restrictive than the AICPA rules (see the discussion of recent proposed revisions to the AICPA rules in the section of this Alert titled "AICPA Ethics Developments." In planning the audit, the auditor should consider the effects of any nonaudit services performed on the auditor's independence for current, future, and planned audit services.

.34 To comply with the provisions governing non-audit services, audit organizations must meet two overarching principles. The first bars audit organizations from performing management functions or making management decisions for their auditees; the second prohibits audit organizations from auditing their own work or providing nonaudit services when the services are material or significant to the subject matter of the audit. If a non-audit service does not conflict with either principle, an audit organization may perform the service as long as it complies with each of the following safeguards (see paragraph 3.25 of Amendment No. 3 to *Government Auditing Standards* for a more detailed description of the safeguards):

- Personnel providing the nonaudit service cannot plan, conduct, or review audit work related to the nonaudit service. Audit and non-audit work must be performed by separate engagement teams. (When

an audit organization provides 40 or fewer hours of non-audit services related to a specific audit engagement, this safeguard requiring separate engagement teams is waived but the auditors must observe the two overarching principles and other safeguards described in this paragraph.)

- The scope and extent of audit work cannot be reduced beyond the level that would be appropriate if the nonaudit work were performed by an unrelated party.
- The audit organization should document its consideration of the nonaudit service, including its rationale that providing the service does not violate the two overarching principles.
- The audit organization should establish and document an understanding with management regarding the objectives, scope of work, and deliverables of the nonaudit service, including an understanding that management is responsible for the results of the service.
- The audit organization's quality control system should include policies and procedures that ensure consideration of the effect of the nonaudit service on ongoing, planned, and future audits.
- Where a nonaudit service is deemed to conflict with the audit (because the service violates one or both of the overarching principles), the audit organization should communicate to management—before beginning the non-audit service engagement—that it will be unable to perform subsequent audit work related to the subject matter of the non-audit service.
- For audits selected during peer review, the audit organization should identify to its peer reviewer all related non-audit services and provide all related audit documentation.

.35 *Government Auditing Standards* describe both non-audit services that are expressly prohibited and others that are permissible (as long as the auditor complies with the two overarching principles and all required safeguards noted above). The standards also state that audit organizations can perform routine activities for the audited entity and management without impairing their independence—provided the audit organization neither makes management decisions nor performs management functions. Such ordinary services do not violate the overarching principles and are not subject to the safeguards.

Overhaul to Remaining Sections of Government Auditing Standards

.36 The GAO issued a comprehensive revision to *Government Auditing Standards* on June 25, 2003. This is the fourth revision of the overall standards since they were first issued in 1972. This revision of the standards supersedes the 1994 revision, including Amendments No. 1 through 3 (note that the content of these Amendments was incorporated into the revision).

.37 The revision affects all chapters of the Yellow Book, including those relating to both financial and performance audits. Among other things, the proposed changes are intended to clarify the types of audits and services that are performed under the Yellow Book, strengthen and streamline certain provisions of it, and improve understandability of the standards. The revisions are effective for financial audits and attestation engagements of periods ending on or after January 1, 2004, and for performance audits beginning on or after January 1, 2004. Early application is permissible. Some of the more significant changes are that the revision:

- Adds a new chapter on attestation engagements that includes additional field work and reporting standards over and above what would be required under the AICPA's attestation standards.
- Requires that auditors collectively possess the technical knowledge, skills, and experience necessary to be competent for the type of work being performed before beginning the work on the assignment.
- Clarifies that the 80 hours of continuing professional education and training that is required under the Yellow Book every two years should directly enhance the auditor's professional proficiency to perform audits and/or attestation engagements. During the next year, the GAO is expected to modify its existing *Interpretation of Continuing Education and Training Requirements—Government Auditing Standards* (see

related discussion in the section of this Alert titled, “References for Additional Guidance”) to more specifically address this new clarification and whether certain courses (for example, those related to taxation) would count toward the 80 hour requirement.

- For financial statement audits, adds a requirement for auditors to be alert to situations or transactions that could indicate abuse, and if indications of abuse exist that could significantly affect the financial statement amounts or other financial data, to apply auditing procedures specifically directed to ascertaining whether abuse has occurred and the effect on the financial statement amounts or other financial data.

Help Desk—You can obtain the new 2003 version of Government Auditing Standards (which includes the independence requirements from Amendment No. 3), the independence question and answer document, and a summary of the significant changes made since the 1994 revision of the standards from the GAO Web site at www.gao.gov/govaud/ybk01.htm.

Recently Issued AICPA Auditing and Attestation Standards

.38 During the last year the AICPA’s Auditing Standards Board (ASB) has issued the following auditing and attestation standards. Although some do not specifically address issues associated with your single audits, you should still be aware of them as they could affect the work you do on the financial statement portion of the single audit. The standards are identified by title below. Only those that might have some impact on your single audit are described in more detail. You can look to the *Audit Risk Alerts State and Local Government Developments—2003* [AAM section 8070] and *Not-for-Profit Organizations—2003* [AAM section 8120] for further discussion of the financial statement audit implications of these standards.

- Statement on Auditing Standards (SAS) No. 98, *Omnibus Statement on Auditing Standards—2002*. With the exception of the effective date of the portions of this standard that amend SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, and rescind Auditing Interpretation No. 6, “Responsibilities of Service Organizations and Service Auditors With Respect to Subsequent Events in a Service Auditor’s Engagement,” of SAS No. 70 (AU sec. 9324.40–.42) (effective for reports issued on or after January 1, 2003), all amendments were effective when SAS No. 98 was issued. One change that you should be aware of as a result of this standard is an amendment to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550.07). It clarifies that if supplementary or other information has been subjected to the auditing procedures applied in the audit of the basic financial statements, the auditor may express an opinion on whether such information is fairly stated in all material respects, in relation to the basic financial statements taken as a whole. It also describes, in more detail, the auditor’s reporting on the information and that the auditor should use the guidance provided in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551.12 and .14), as amended. While such “in relation to” reporting has been common practice in the single audit arena (that is, the auditor reports on the schedule of expenditure of federal awards in relation to the financial statements taken as a whole), the auditing standards never clearly addressed whether such reporting was permissible when the information was included in a client-prepared document. SAS No. 98 clarifies this issue.
- SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). This SAS is effective for audits of financial statements for periods beginning on or after December 15, 2002, with early application permissible. You should note that this new standard is written from a financial statement audit perspective. That is, it provides standards and guidance to the auditor in fulfilling his or her responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether due to error or fraud.
- SAS No. 100, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722). It is effective for interim periods within fiscal years beginning after December 15, 2002, with earlier application permitted.

- SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 328). It is effective for audits of financial statements for periods beginning on or after June 15, 2003, with earlier application permitted.
- Statement on Standards for Attestation Engagements (SSAE) No. 12, *Amendment to Statement on Standards for Attestation Engagements No. 10*, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101). This omnibus standard makes changes to the attestation standards, where applicable, that are consistent with those made to the auditing standards via SAS No. 98.

.39 However, you should also note that the Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, states that as part of assessing audit risk in a single or program-specific audit, the auditor should specifically assess the risk of material noncompliance with a major program's compliance requirements occurring due to fraud. The auditor must then consider that assessment in designing the audit procedures to be performed. Although SAS No. 99 applies only to an audit of financial statements (that is, its requirements do not apply to a compliance audit), you may want to consider the guidance set forth therein when planning and performing your audit of an auditee's compliance with specified requirements applicable to its major programs. Additionally, you may wish to refer to the AICPA Practice Aid titled *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*, which identifies example risk factors that relate to recipients of federal awards.

- SAS No. 100, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722). It is effective for interim periods within fiscal years beginning after December 15, 2002, with earlier application permitted.
- SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1, AU sec. 328). It is effective for audits of financial statements for periods beginning on or after June 15, 2003, with earlier application permitted.
- Statement on Standards for Attestation Engagements (SSAE) No. 12, *Amendment to Statement on Standards for Attestation Engagements No. 10*, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101). This omnibus standard makes changes to the attestation standards, where applicable, that are consistent with those made to the auditing standards via SAS No. 98.

Proposed AICPA Auditing and Attestation Standards

.40 The ASB has released several exposure drafts that will primarily affect the financial statement audit portion of your single audit. The proposals are identified here by title. Only those that might have some impact on your single audit are described in more detail.

- *Proposed SAS related to audit risk.* The ASB released seven proposed SASs related to the audit risk assessment process to change audit practice to result in more efficient audits. The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model. The proposed SASs are:
 - *Amendment to SAS No. 95, Generally Accepted Auditing Standards*
 - *Audit Evidence* (which would supersede SAS No. 31 of the same name [AICPA, *Professional Standards*, vol. 1, AU sec. 326])
 - *Audit Risk and Materiality in Conducting an Audit* (which would supersede SAS No. 47 of the same name [AICPA, *Professional Standards*, vol. 1, AU sec. 312])
 - *Planning and Supervision* (which would supersede SAS No. 22 of the same name [AICPA, *Professional Standards*, vol. 1, AU sec. 311])
 - New SASs titled *Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement* and *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (which together would supersede SAS No. 45, *Substantive Tests Prior to the Balance-Sheet Date* [AICPA, *Professional Standards*, vol. 1, AU secs. 313 and 334], and SAS No. 55,

Consideration of Internal Control in a Financial Statement Audit [AICPA, *Professional Standards*, vol. 1, AU sec. 319])

— An amendment to SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350)

- *Proposed SAS, Sarbanes-Oxley Omnibus.* Although many of the revisions in this proposal would only apply to Securities and Exchange Commission (SEC) engagements, there are a few proposed changes that could affect your single audits. For example, the statement would amend SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), as amended, to establish a definition of an audit committee and to revise certain existing communication requirements or add new requirements.
- Proposed SASs titled *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With Financial Statement Audit* and *Amendment to SAS No. 100, Interim Financial Reporting*; proposed SSAE titled *Reporting on an Entity's Internal Control Over Financial Reporting*.
- Proposed SAS titled *Communication of Internal Control Related Matters Noted in an Audit*, which would supersede SAS No. 60 (AICPA, *Professional Standards*, vol. 1, AU sec. 325), of the same name. One result of this proposed standard is that the term *reportable condition* would be replaced by the term *significant deficiency* to comply with the SEC's terminology. If the standards are finalized as proposed, this would result in possible future report wording changes to your single audit reports (for example, in the reporting required under *Government Auditing Standards* and Circular A-133).

Help Desk—For information about the current status of these proposed standards, go to the AICPA Web site at www.aicpa.org/members/div/auditstd/drafts.htm.

Issuance of New AICPA Audit Guide for Performing OMB Circular A-133 Audits

.41 This new Audit Guide titled *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (the Single Audit Guide) is the former Statement of Position (SOP) 98-3 of the same name. Until this year, that guidance had been included as an SOP in an appendix to both the GASB 34 and Non-GASB 34 editions of the AICPA's state and local government Audit and Accounting Guides and in the not-for-profit organizations Audit and Accounting Guide. The AICPA ASB decided to convert the SOP into an AICPA Audit Guide because the content and guidance in the SOP are more similar to that which would be included in an Audit Guide and also to make it more clear that, like other AICPA Audit Guides, it is updated each year for conforming changes. The new Guide does not supersede the guidance that appeared in SOP 98-3 but rather changes its format from an SOP to an Audit Guide. It is now one of the AICPA's primary sources of authoritative guidance for performing audits under the Single Audit Act, Circular A-133, and *Government Auditing Standards*.

.42 Under SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150), both an Audit Guide and an SOP are considered Interpretive Publications. Interpretive Publications are recommendations on the application of SASs in specific circumstances, including engagements for entities in specialized industries. If you do not apply the auditing guidance included in an applicable Interpretive Publication, you should be prepared to explain how you complied with the SAS provisions addressed by such auditing guidance.

.43 Each year since 1998, AICPA staff has updated the SOP and, in its new form as a separate Guide, this year is no different. Updates for this Guide include conforming changes related to recent auditing standards and other changes in guidance, for example, changes resulting from recently adopted Amendment No. 3, "Independence," to *Government Auditing Standards* and the AICPA's Audit and Accounting Guide *Audits of State and Local Governments* (GASB 34 Edition). Also, the illustrative *Government Auditing Standards* and Circular A-133 reporting included in Appendix D of the Single Audit Guide has been updated to reflect wording changes that would be necessary for audits performed using the provisions of the recently issued Audit and Accounting Guide *Audits of State and Local Governments* (GASB 34 Edition).

Help Desk—The product number for the Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, is 0012743kk. To place your order for this Guide, you can call AICPA Member Services at (888) 777-7077. Also see the “References for Additional Guidance” section later in this Alert.

AICPA Ethics Developments

Revision of Interpretation 101-10

.44 Ethics Interpretation No. 101-10, “The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements,” of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.12), discusses the effect on an auditor’s independence of relationships with entities included in governmental financial statements. The AICPA issued a revision of this Interpretation (effective March 2003) that reflects new wording related to changes resulting from issuance of GASB Statement No. 34. In addition, certain changes were made to the Interpretation to conform it to the AICPA’s new independence rules that were issued in November 2001 (that is, engagement-team focused approach to independence). Finally, the revision changes the focus of the Interpretation, which had been based on the commercial model concept of *financial control* to an *accountability* focus, which is more consistent with the government reporting model.

Help Desk—You can find the revision to the Interpretation in the March 2003 issue of the AICPA’s Journal of Accountancy. You can access the Journal’s Web site at www.aicpa.org/pubs/jofa/joahome.htm.

Revisions to Rule 101—Independence for Nonattest Services

.45 In June 2003, the AICPA’s Professional Ethics Executive Committee issued revisions to Interpretation No. 101-3, “Performance of Other Services,” of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05), and deleted Interpretation No. 101-13, “Extended Audit Services,” of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.15), and related *Ethics Rulings*. In the area of nonattest services, the Committee adopted several new requirements, including those that would require members to:

- Comply with regulations of certain regulatory bodies (such as the state boards of accountancy, the SEC, and the GAO) when performing services for attest clients that are governed by such regulators’ independence rules
- Assess the client’s willingness and ability to oversee permitted nonattest services
- Document various aspects of the permitted nonattest services engagement before performing nonattest services

In addition, the committee adopted more restrictive rules for certain services:

- Performing appraisal, valuation, and actuarial services would impair independence if the results of the service will be material to the client’s financial statements and if the services involve a significant degree of subjectivity.
- Performing certain financial information systems design and implementation services would impair independence in certain circumstances.

.46 The committee also clarified existing rules for bookkeeping and internal audit assistance services and proposed an increase in the allowable balance that individuals subject to independence restrictions could have through credit cards and cash advance accounts.

.47 The rule revisions generally become effective on December 31, 2003; however, there is also transitional effective date guidance included in the revised Interpretation. Independence would not be impaired as a result

of the more restrictive requirements of Interpretation No. 101-3, provided the provision of any such nonattest services are pursuant to arrangements in existence on December 31, 2003, and are completed by December 31, 2004, and the member was in compliance with the preexisting requirements of the Interpretation.

Help Desk—To access related information, go to the AICPA Web site at www.aicpa.org/download/ethics/interp_revisions_jun03.pdf.

Reissuing Single Audit Reports

.48 As noted in the section of this Alert titled “Adherence to Professional Standards and Requirements,” the federal OIGs have been very active in performing quality control reviews. In some cases where problems have been noted by the OIGs, there has been a need for the auditor to perform additional test work or to revise the schedule of expenditures of federal awards (SEFA). Auditors have been asking about the appropriate actions to take with regard to the auditor’s single audit reporting once such problems arise. If you find yourself in this circumstance, you should first look to SAS No. 1, section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 561). The following discussion might also be of assistance.

.49 If an error is found that results in the addition of a major program (for example, because the type A program threshold changes due to missing programs in the SEFA resulting in a new major program or because a type A program that should have been a major program because it had not been tested in the previous two years was overlooked), you will need to perform the appropriate testing on the new major program. It will then be necessary to reissue your Circular A-133 reporting with a dual date that references the new program. Your report wording might remain the same (for example, if your previous report was unqualified and your opinion on the additional major program is also unqualified) or need to be revised (for example, if your previous report was unqualified and your opinion on the additional major program is qualified) depending on the results of the procedures you perform on the new major program. You should also revise the schedule of findings and questioned costs to reflect the additional major program and to include any additional findings and questioned costs that result from your testing. You should also consider modifying the title of the schedule to indicate that it has been restated. Finally, if the SEFA previously identified major programs and a change needs to be made due to the new major program, your reporting on the SEFA will need to be reissued. See the following paragraph for further discussion on the SEFA reporting.

.50 If you are in a situation where the SEFA needs to be restated (for example, because a program needs to be added or deleted or a program expenditure amount needs to be revised), you have several considerations. If your reporting on the SEFA had previously been included in the report on the financial statements, you may want to consider reissuing your financial statement report (using the original date) and issuing a new separate in-relation-to opinion on the SEFA that carries a dual date. If your reporting on the SEFA had previously been included in your Circular A-133 reporting, you could reissue that report, including the reporting on the SEFA, with a dual date. Finally, if you had issued a separate SEFA report to begin with, you could reissue that report with a dual date. In all cases, the dual dated report should refer to a new footnote to the SEFA (that should be added by your client) explaining the restatement.

.51 In either of the above scenarios, it is not likely that your *Government Auditing Standards* reporting would be affected. That is because the Yellow Book report relates to your audit of the financial statements. However, if you have to audit a new major program and find noncompliance that would be direct and material to the financial statements, you would follow the guidance in SAS No. 46, *Consideration of Omitted Procedures After the Report Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 390).

.52 In a few cases, the OIGs have not been satisfied with the amount of test work that has been performed by the auditor in a single audit and have asked the auditor to perform additional procedures. You should refer to the guidance in SAS No. 46 for additional guidance if you find yourself in this situation.

.53 Finally, if as a result of any of the scenarios described above, changes are needed to the data collection form and reporting packages that have already been submitted to the FAC, you should follow the instructions for “Paper Submission” revision at the FAC Web site at harvester.census.gov/sac/collect/revisions_Main.html. All resubmissions to the FAC (of either a revised form or reporting package) must be accompanied by a newly signed data collection form.

References for Additional Guidance

AICPA

Web Site

.54 AICPA Online (www.aicpa.org) is the AICPA’s Web site on the Internet. The site offers users the opportunity to stay abreast of developments in accounting, auditing, and professional ethics. Online resources include professional news, membership information, state and federal legislative updates, AICPA press releases, speeches, exposure drafts, and a list of links to other accounting- and finance-related sites. The AICPA Web site also features a “Talk to Us” section, allowing users to send e-mail messages directly to AICPA representatives or teams. The AICPA Web site includes a separate section that deals with Circular A-133 audit issues, including a document that provides unofficial answers to frequently asked questions, at www.aicpa.org/belt/a133main.htm.

Order Department (Customer Service Center)

.55 To order AICPA products, call the Customer Service Center at (888) 777-7077 or fax to (800) 362-5066. 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., Eastern Standard Time. Also, visit the CPA2Biz Web site at www.cpa2biz.com to obtain product information and place online orders.

Publications

.56 The following AICPA publications may be of interest to auditors of entities that receive federal funding.

- *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*—This Audit Guide (previously issued as SOP 98-3 of the same name—see the section of this Alert titled “Issuance of New AICPA Guide for Performing OMB Circular A-133 Audits”) provides guidance on the auditor’s responsibilities when conducting a single audit or program-specific audit. It is updated annually for conforming changes (product no. 0012743kk).
- *AICPA Professional Standards*—These include SASs and related Interpretations, Statements on Standards for Attestation Engagements, and the AICPA Code of Professional Conduct, among other things (product no. 005103kk).
- *Audits of State and Local Governments (GASB 34 Edition)*—This Audit and Accounting Guide presents guidance on the application of GAAS to audits of financial statements of state and local governments (product no. 012663kk).
- *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*—This Audit and Accounting Guide presents guidance on the application of GAAS to audits of financial statements of state and local governments (product no. 012563kk).
- *Health Care Organizations*—This Audit and Accounting Guide presents guidance on the application of GAAS to audits of financial statements of health care organizations (product no. 012613kk).
- *Not-for-Profit Organizations*—This Audit and Accounting Guide presents guidance on the application of GAAS to audits of financial statements of not-for-profit organizations (product no. 012643kk).

- *Checklists and Illustrative Financial Statements for State and Local Governments (Non-GASB 34 Edition and GASB 34 Edition)*—Updated annually, this publication provides checklists and illustrations of financial statements, note disclosures, and auditors' reports, including reports in accordance with *Government Auditing Standards* and the Single Audit Act. Note: This volume includes both the non-GASB 34 and GASB 34 editions of the checklists in one handy binder (product no. 009033kk).
- *Audit and Accounting Manual* (product no. 005133kk)—Updated annually, this publication has an extensive section of internal control questionnaires and audit programs for audits of governmental entities, including audits in accordance with the Single Audit Act.

Continuing Professional Education Courses

.57 The AICPA offers continuing professional education (CPE) related to single audits in the form of both group-study and self-study courses, and in print and video format.

.58 Group-study courses include the following:

- Advanced Auditing of HUD-Assisted Projects
- Applying A-133 to Nonprofit and Governmental Organizations
- Audits of HUD-Assisted Projects
- Governmental Accounting and Auditing Update
- Governmental and Nonprofit Annual Update
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations
- Workpaper Preparation Techniques for Government and Nonprofit Organizations
- The Revised Yellow Book: *Government Auditing Standards*

.59 Self-study courses include the following:

- Advanced Auditing of HUD-Assisted Projects (product no. 730188kk)
- Applying A-133 to Nonprofit and Governmental Organizations (product no. 730198kk)
- Audits of HUD-Assisted Projects (product no. 730293kk)
- Governmental Accounting and Auditing Update (product no. 736472kk)
- Solving Complex Single Audit Issues for Government and Nonprofit Organizations (product no. 734406kk)
- Workpaper Preparation Techniques for Government and Nonprofit Organizations (product no. 732631kk)
- The Revised Yellow Book: *Government Auditing Standards* (product no. 736111kk)

.60 The AICPA also offers the following video courses:

- Governmental Accounting and Auditing Update (product no. 186476kk)
- The Revised Yellow Book: *Government Auditing Standards* (product no. 734406kk)
- Applying A-133 to Nonprofit and Governmental Organizations (product no. 187200kk)

.61 Information on these and other AICPA government and not-for-profit auditing courses is available at www.cpa2biz.com or by calling (888) 777-7077.

Online CPE

.62 AICPA InfoBytes, offered exclusively through CPA2Biz.com, is the AICPA's flagship online learning product. Selected as one of *Accounting Today's* top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay \$149 (nonmember, \$369) for a new subscription and \$119 (nonmembers, \$319) for the annual renewal. Divided into 1- and 2-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. Governmental topics include the Yellow Book, Circular A-133 auditing, GASB Statement No. 34, HUD, industry updates, and other pertinent issues. To register or learn more, visit www.cpa2biz.com/infobytes.

Industry Conference and Training Program

.63 The AICPA will hold its 20th annual National Governmental Accounting and Auditing Update Conference on August 25–27, in Washington, DC, and again on September 21–23, 2003, in Tempe, AZ. This 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.

.64 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 19–22, in Baltimore, MD. This program is designed for practitioners or accountants, auditors, and other staff in government who want in-depth, hands-on training in government accounting and auditing.

.65 For more information about the conference or the training program, please contact the Customer Service Center at (888) 777-7077 or the Web site for cpa2biz at www.cpa2biz.com.

Accounting and Auditing Technical Hotline

.66 The Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077 or go to the AICPA's Web site at www.aicpa.org.

Ethics Hotline

.67 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.

Fax Hotline

.68 The AICPA has a 24-hour fax system that enables interested persons to obtain information that includes, for example, current AICPA comment letters, conference brochures and registration forms, CPE information, AcSEC actions, and legislative news. To access the hotline, dial (201) 938-3787 from a fax machine and follow the voice cues.

Federal Agencies—Administrative Regulations

.69 Most federal agencies issue general administrative regulations that apply to their programs and that 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. Those regulations are included in the *Code of Federal Regulations*.

.70 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

.71 The GAO home page, on the Internet at www.gao.gov, contains links to the hundreds of reports and testimony to Congress each year on a variety of subjects, including accounting, budgeting, and financial management. Hard copies of GAO reports and testimony can be obtained from the GAO, P.O. Box 37050, Washington, DC 20013; phone (202) 512-6000; fax (202) 512-6061; or www.gao.gov/cgi-bin/ordtab.pl.

.72 The GAO's Web site is updated daily and also includes Comptroller General decisions and legal opinions, GAO policy documents, and special publications. You may subscribe to GAO daily electronic alerts using the form at www.gao.gov/subtest/subscribe.html.

.73 The following publications are available on the GAO Web site at www.gao.gov/govaud/ybk01.htm. The first three publications also are available through the Superintendent of Documents, U.S. Government Printing Office (GPO), P.O. Box 371954, Pittsburgh, PA 15250-7954; phone (202) 512-1800; fax (202) 512-2250; or bookstore.gpo.gov/index.html.

- *Government Auditing Standards, 2003 Revision* relates to financial and performance audits of governmental organizations, programs, activities, and functions, and of governmental funds received by contractors, nonprofit organizations, and other nongovernmental organizations. All previous amendments to the previous 1994 Revision of the Yellow Book (that is, Amendments No. 1 through No. 3) have been incorporated into the 2003 Revision. As of the date of this Alert, the 2003 Revision was available electronically only on the GAO Web site. Details on ordering a hard copy print version will be placed on the GAO Web site once the print version is available.
- *Government Auditing Standards: Answers to Independence Questions* responds to questions related to the Yellow Book independence standard's implementation time frame, underlying concepts, and application in specific nonaudit circumstances.
- *Interpretation of Continuing Education and Training Requirements—Government Auditing Standards* establishes specific CPE requirements for auditors working on audits performed in accordance with those standards. This Interpretation guides audit organizations and individual auditors on implementing the CPE requirements by answering the most frequently asked questions from the audit community. As noted in the section of this Alert titled "*Government Auditing Standards Developments*," the GAO is expected to revise this Interpretation during the upcoming year.

Office of Management and Budget

Circulars

.74 The OMB issues cost and 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 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. The following table includes a list of circulars relevant to single audits. Copies of these circulars are available under the grants management section of the OMB Web site at www.omb.gov/grants.

OMB Circulars Relevant to Single Audits

<i>Circular Number</i>	<i>Title</i>	<i>Issue Date</i>
A-21 (Revised)	<i>Cost Principles for Educational Institutions</i>	August 2000
A-87 (Revised)	<i>Cost Principles for State, Local, and Indian Tribal Governments</i>	August 1997
A-102 (Revised)	<i>Grants and Cooperative Agreements With State and Local Governments</i>	August 1997
A-110 (Revised)	<i>Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations</i>	September 1999
A-122 (Revised)	<i>Cost Principles for Non-Profit Organizations</i>	May 1998
A-133 (Revised)	<i>Audits of States, Local Governments, and Nonprofit Organizations</i>	June 2003

OMB Circular A-133 Compliance Supplement

.75 The Supplement (Appendix B in OMB Circular A-133) sets forth the major federal compliance requirements to consider in a Circular A-133 audit of states, local governments, and not-for-profit organizations that receive federal assistance. You can find the 2003 Supplement (and the preceding 2002 and 2001 Supplements) on the OMB's Web site at the grants management address, www.omb.gov/grants. You may purchase a printed copy (product no. 041-001-00593-5) of the 2003 Supplement from the Government Printing Office at (202) 512-1800.

Other Guidance

.76 Standard forms prescribed by OMB's grants management circulars can be obtained on the grants management section of OMB's Web site (see the previous section of this Alert). The data collection form (Form SF-SAC), which is required to be completed for all Circular A-133 audits, can be completed online at the Federal Audit Clearinghouse Web site at harvester.census.gov/sac. That site also has PDF versions of the data collection form.

.77 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 public. Program information provided by the CFDA includes authorizing legislation and audit requirements. 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 located at www.cfda.gov.

.78 The GSA also makes copies of the CFDA available to certain specified national, state, and local government offices. You can locate those depositories through the GSA Web site at www.gsa.gov. The CFDA also may be purchased from the GPO by calling (202) 512-1800 or through the online bookstore at www.gpo.gov.

PCIE Audit Committee Guidance

.79 The PCIE Audit Committee publishes supplemental, nonauthoritative guidance for federal officials addressing issues arising from the implementation of the Single Audit Act and related OMB Circulars.

.80 Over the years, the PCIE Audit Committee (or its predecessors) has issued a total of six position statements. Most of these position statements are no longer applicable because they were originally developed to address issues related to audits conducted under the Single Audit Act of 1984, Circular A-128, *Audits of State and Local Governments*, and the March 1990 version of Circular A-133.

.81 Note that the PCIE Audit Committee also is responsible for developing nonfederal audit review guidelines in the form of a desk review guide and a quality control review guide. Those guides, which have been updated for the Single Audit Act Amendments of 1996 and the June 1997 revision to Circular A-133, are available at the Inspectors General Web site (www.ignet.gov/pande/audit/mains.html) in the Single Audit Library.

This Audit Risk Alert replaces *Single Audits—2002, Audits of Organizations Receiving Federal Awards: Single Audits Performed in Accordance With Office of Management and Budget Circular A-133*.

.82 The *Single Audits* Audit Risk Alert 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 Audit Risk Alert would also be greatly appreciated. You may e-mail these comments to mfoelster@aicpa.org or write to:

Mary McKnight Foelster
AICPA
Professional Standards and Services
1455 Pennsylvania Avenue, NW
Washington, DC 20004-1081

.83 We also suggest that you review the AICPA *Audit Risk Alert* [AAM section 8010], which is a general update on economic, auditing, accounting, and other professional developments, and the Audit Risk Alerts *State and Local Governmental Developments* [AAM section 8070] and *Not-for-Profit Organizations* [AAM section 8120], which discuss industry-specific financial statement audit considerations. Although not specifically geared toward single audits, these publications might be relevant and valuable to consider in your single audit engagements.

Appendix A

Overview of Key Components of a Single Audit

Each year, the federal government awards billions of dollars to state and local governments and not-for-profit organizations (NPOs). Last year alone, the federal government issued approximately \$400 billion in awards to these entities. These awards include grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, and direct appropriations and federal cost reimbursements. Entities that receive federal funds are subject to audit requirements that are commonly referred to as *single audits*.

Among other things, the Single Audit Act Amendments of 1996 (the Single Audit Act) (Public Law [P.L.]104-156) is intended to promote sound financial management, including effective internal control, with respect to federal awards administered by state and local governments and NPOs. Each year, over 35,000 single audits are performed. Under Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133), those governments or organizations that expend \$300,000 or more in federal awards during the fiscal year must do the following (see the section of this Alert titled “OMB Raises Single Audit Threshold and Revises Other Sections of Circular A-133” for a discussion of recent revisions to the \$300,000 threshold):

1. Maintain internal control for federal programs.
2. Comply with the laws, regulations, and the provisions of contracts or grant agreements.
3. Prepare appropriate financial statements, including the schedule of expenditures of federal awards (SEFA).
4. Ensure that the required single audits are properly performed and submitted when due.
5. Follow up and take corrective actions on audit findings.

Single Audit Objectives

Under Circular A-133, the auditor has additional testing and reporting responsibilities for compliance, as well as internal control over compliance, beyond a financial statement audit performed in accordance with *Government Auditing Standards* and generally accepted auditing standards (GAAS). A single audit has two main objectives:

1. An audit of the entity’s financial statements and the reporting on the SEFA in relation to those financial statements
2. A compliance audit of federal awards expended during the fiscal year (This compliance audit provides a basis for issuing an additional report on compliance related to major programs and on internal control over compliance.)

With regard to compliance, the auditor is required to determine whether the entity complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that have a direct and material effect on each major program. The auditor is required to express an opinion on whether the entity complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each major program. Where applicable, the auditor is also required to refer to a separate schedule of findings and questioned costs.

With regard to internal control over compliance, the auditor is required to do the following, in addition to the requirements of *Government Auditing Standards*:

- Perform procedures to obtain an understanding of internal control over 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 major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.
- Perform tests of internal control (unless the internal control is likely to be ineffective in preventing or detecting noncompliance).

Single Audit Guidance

The primary sources of AICPA audit standards and guidance regarding single audits are Statement on Auditing Standards (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), and the AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (the Single Audit Guide). The Single Audit Guide provides guidance on the auditor's responsibilities when conducting a single audit or program-specific audit in accordance with the Single Audit Act and Circular A-133.

Circular A-133 provides for the issuance of a compliance supplement to assist auditors in planning and performing the required audits. The OMB Circular A-133 *Compliance Supplement* (the Supplement) identifies important compliance requirements that the federal government expects to be considered as part of an audit in accordance with the Single Audit Act and Circular A-133. Use of the Supplement is mandatory.

The Supplement is updated annually and contains specific audit guidance relating to individual federal programs. The Supplement provides a source of information for auditors to understand federal program objectives, procedures, and compliance requirements, as well as audit objectives and suggested audit procedures for determining compliance with these requirements. See the discussion of the 2003 Supplement in the section of this Alert titled "Circular A-133 Audit Guidance Update."

Federal Audit Clearinghouse: Role and Responsibilities

The Federal Audit Clearinghouse (FAC), the organization the OMB designated to receive single audit reports from federal award recipients, received about 38,200 single audit reports with a fiscal year end date in 2001. About 7,200, or approximately 19 percent, of these reports contained audit findings.

The FAC processes incoming reporting packages and related data collection forms, maintains a government-wide database of audits, distributes reports with audit findings to individual federal agencies for audit resolution, and maintains an archival copy of all reports. The FAC provides an efficient and effective method of (1) processing, distributing, and archiving single audit reports; (2) monitoring recipients' compliance with requirements to submit reports required by the Single Audit Act; and (3) capturing summary information on audit results.

Help Desk—The FAC database of all complete data collection form information is accessible to federal agency users and the public through the FAC Web site at <http://harvester.census.gov/sac>.

Audit Quality Monitoring by Cognizant Agencies

Circular A-133 requires that cognizant agencies for audit (meaning those agencies with specific single audit oversight responsibilities for recipients expending more than \$25 million annually in federal awards) conduct or obtain quality control reviews of selected single audits (see the section of this Alert titled "OMB Raises Single Audit Threshold and Revises Other Sections of Circular A-133" for a discussion of recent revisions to the \$25 million threshold). These efforts include desk reviews and quality control reviews (QCRs). Federal OIGs require corrective action on audit reports that are *technically deficient* or *substandard*. For audits that are substandard, the OIGs generally refer auditors who are CPAs to state licensing officials and, if they are members, to the AICPA for disciplinary action.

Desk reviews. All single audit reporting packages undergo an initial screening to determine whether they are complete when submitted to the FAC in Jeffersonville, IN. Some federal Offices of Inspectors General (OIGs) or another office within the agency perform a desk review when the reporting package arrives at the federal agency. The President's Council on Integrity and Efficiency (PCIE) has issued a desk review guide and checklist, titled *Uniform Guide for Initial Review of A-133 Audit Reports*, for use by OIGs when performing desk reviews.

Quality control reviews. QCRs are more detailed than desk reviews and typically involve the OIG examining the auditor's work. The objectives of a QCR of a single audit are to (1) ensure that the audit was conducted in accordance with applicable standards and that it meets the single audit requirements, (2) identify any follow-up audit work needed, and (3) identify issues that may require management attention. QCRs are performed using the PCIE *Uniform Quality Control Review Guide*.

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Appendix B

Common Engagement Deficiencies Noted in Peer Reviews, Ethics Investigations, and Federal OIG Quality Control Reviews

As noted earlier in this Alert, both the AICPA peer review and disciplinary processes continue to indicate that there are problems in the single audits they are reviewing. Federal Offices of Inspectors General (OIGs) have also found problems based on their quality control reviews of single audit work that are consistent with those found by the AICPA. The following discussion describes the most common deficiencies being found. You should consider reviewing your firm's policies and procedures to see whether your single audits also might have these kinds of issues.

- *Failure to audit type A programs as major because of errors made in determining the type A/type B program dollar threshold.* Circular A-133 includes criteria for determining the dollar threshold for type A programs. Any program that does not meet those criteria is considered a type B program. No rounding is permitted for that threshold. Some auditors made mathematical computation errors in determining the threshold and some erroneously based calculations on interim rather than final federal awards expended amounts. You should note that federal awards expended for purposes of determining type A and type B programs are the amount of cash and noncash awards, after all adjustments are made, in the *final* current-year schedule of expenditures of federal awards (SEFA), including the notes thereto. An auditor who uses the prior-year schedule or preliminary current-year estimates to plan the audit should recalculate the threshold for type A programs based on the final amounts to ensure that federal awards are properly classified as type A or B.
- *Failure to audit all programs included in a cluster of programs.* Clusters are defined in Part 5 of the Supplement and should be considered as one program in determining major programs. Auditors made errors in identifying programs as part of a program cluster.
- *Failure to meet the percentage-of-coverage requirement in Circular A-133, section 520(f).* The percentage-of-coverage requirement is applied as the last step in the risk-based approach and must always be met. At least one program must always be audited as a major program. In some cases, there were errors in the reviewed audits' compliance with the percentage-of-coverage requirement.
- *Inadequate or outdated reference material.* The auditor used inadequate or outdated reference material related to the engagement performed. Be sure to be familiar with new Statements on Auditing Standards (SASs) and accounting standards that are issued. Further, you should ensure that you are using the most up-to-date versions of the Supplement, Yellow Book, and the Single Audit Guide.
- *Documentation problems noted in various areas.* Internal control and compliance tests were not always adequately documented to support the reports issued. In some cases the auditor did not document that an auditee was considered a low-risk auditee (to support the reduced testing that was performed). Further, in a few other cases items such as the subsequent events review and litigation follow-up were not documented. SAS No. 96, *Audit Documentation*, provides guidance on the content, retention, and confidentiality of audit documentation as required by generally accepted auditing standards (GAAS). Among other things, SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), requires audit documentation to be sufficient to enable members of the engagement team with supervision and review responsibilities to understand the nature, timing, extent, and results of auditing procedures performed, and the evidence obtained. *Government Auditing Standards* includes an additional standard that requires audit documentation to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain the evidence that supports the auditor's significant conclusions and judgments. You should keep these SAS No. 96 and *Government Auditing Standards* requirements in mind when you

are preparing your audit documentation. It is possible that problems with audit documentation could be the root of many of the other problems discussed in this section.

- *Problems with the GAAS audit of the financial statements.* Generally accepted accounting principles (GAAP) requirements for the classification, accounting, and reporting for particular funds and for disclosures were not followed in all cases. Further, the auditor's report was not always qualified for GAAP departures. While Circular A-133 does not require the financial statements to be prepared in conformity with GAAP, if the entity has chosen to follow GAAP, the financial statements should include all appropriate requirements. Further, the auditor's report should be appropriately modified for any GAAP departures.
- *Engagement letter deficiencies.* The engagement letter did not include proper references to Circular A-133 requirements or record retention policies, or include a copy of the latest peer review report. Refer to SAS No. 83, *Establishing an Understanding With the Client*, as amended by SAS No. 89, *Audit Adjustments* (AICPA, *Professional Standards*, vol. 1, AU sec. 310.06-.07), for a listing of the matters that should generally be included when the auditor establishes an understanding with the auditee. The Single Audit Guide also includes additional matters that the auditor might want to consider in the communication when engaged to perform a single audit.
- *Inadequate Government Auditing Standards reporting.* The required *Government Auditing Standards* reporting for internal control or compliance were not prepared or were not referred to in the report on the financial statements. Remember to prepare a Yellow Book report when the audit is required to be performed in accordance with *Government Auditing Standards* (either by law, regulation, or contract). Remember, also, that there is a required linkage paragraph required in the report on the financial statements that informs the reader that the Yellow Book report has been issued and that it is an integral part of the audit and should be read in conjunction with the financial statement report. The Single Audit Guide includes illustrative Yellow Book reporting with recommended AICPA wording.
- *Inadequate Circular A-133 reporting.* The appropriate Circular A-133 reporting was not included in some cases. In others, the appropriate report wording was not used. You are required to issue a Circular A-133 report in every single audit. The Single Audit Guide includes illustrative Circular A-133 reporting with recommended AICPA wording.
- *Inappropriate compliance opinion.* Sometimes the Circular A-133 report was not modified when it appeared that it should be. In other words, an unqualified opinion was provided when there were material instances of noncompliance. When the audit of an auditee's compliance with requirements applicable to a major program detects material instances of noncompliance with those requirements, you should express a qualified or adverse opinion. You should also consider whether the noncompliance is the result of a related reportable condition or material weakness and, if so, report it in the Circular A-133 report. Chapters 6 and 10 of the Single Audit Guide discuss compliance auditing requirements and auditor reporting. Further, chapter 3 of the Single Audit Guide discusses materiality differences between the single audit and the financial statement audit.
- *Problems with compliance and internal control work.* In some cases, the required compliance testing was not performed, sometimes because the auditor did not follow the guidance in Part 7 of the Supplement for identifying the applicable compliance requirements to test and report on. In other cases, internal control and compliance tests were not adequately designed or documented to support the reports issued. In performing compliance tests, be sure that you have identified which of the applicable compliance requirements may have a direct and material effect on each major program. It is imperative that you use the most recent version of the Supplement to make this identification. If the program you are auditing is not included in the Supplement, you should follow the guidance in Part 7 of the Supplement for identifying the applicable compliance requirements. Further, in performing compliance tests, be sure to consider relevant portions of the entity's internal control over compliance. Remember that you must test controls (to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program) unless they are

likely to be ineffective in preventing or detecting noncompliance. Consult the Single Audit Guide, chapters 6 and 8, for detailed guidance on both compliance and internal control testing.

- *Audit findings and supporting documentation lacking.* Audit findings reported by auditors in the schedule of findings and questioned cost have been found to be lacking required information. Further, in some cases federal agencies have reviewed audit documentation supporting audit findings for purposes of assisting them in seeking recovery of questioned costs. In performing those reviews, they have found that the audit documentation lacked information on the specific items tested and the transactions for which exceptions were found. Circular A-133 requires that audit findings should be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for federal agencies and pass-through entities to arrive at a management decision. You should refer to chapter 10 of the Single Audit Guide for a discussion of the specific requirements of Circular A-133 as it relates to audit findings. Further, you should ensure that your audit documentation clearly identifies the work performed and conclusions reached. Remember that SAS No. 96 requires that audit documentation related to tests of operating effectiveness of controls and substantive test of details that involve inspection of documents or confirmation to include an identification of the items tested. See the bullet above that covers single audit documentation problems in general.
- *Inadequate management representation letter.* The management representation letter did not follow the requirements of SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), as amended, or include the additional representations required by the Single Audit Guide for a Circular A-133 audit. Refer to both SAS No. 85 and the Single Audit Guide to ensure all required components of the management representation letter are included.
- *Issues with the schedule of expenditures of federal awards.* In some instances, the SEFA was not presented or reported upon. In others, the schedule was presented but it did not accurately reflect the federal expenditures of the auditee and the auditor's reporting on the schedule was not modified. Circular A-133 requires the auditor to determine whether the SEFA is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole. The schedule, prepared by the auditee, reports the total expenditures for each federal program. Refer to chapters 5 and 10 of the Single Audit Guide, which cover the identification of federal awards, the general presentation requirements governing the schedule, pass-through awards, noncash awards, endowment funds, and the auditor's reporting on the schedule.
- *Noncompliance with Yellow Book continuing professional education (CPE) requirements.* Under the Yellow Book, certain auditors must complete 80 hours of CPE every two years, with at least 24 of those hours in subjects directly related to the government environment and to government auditing. If the audited entity operates in a specific or unique environment, auditors should receive training related to that environment. Also, the GAO has issued an *Interpretation of Continuing Education and Training Requirements—Government Auditing Standards* that is helpful in understanding the specific CPE requirements for auditors working on audits performed in accordance with *Government Auditing Standards*. (See the discussion in the section of this alert titled "Government Auditing Standards Developments" for upcoming changes to the CPE requirements of the Yellow Book.)
- *Concurring review process failed.* In several of the cases, engagements that were reviewed before completion by a concurring reviewer had a multitude of problems. If your firm uses concurring reviewers as part of your quality control system, you should consider ensuring that the reviewer has knowledge of *Government Auditing Standards* and Circular A-133 requirements.

[The next page is 8931.]

AAM Section 8230

Manufacturing Industry Developments—2002/03

How This Alert Helps You

.01 This Audit Risk Alert is intended to help you plan and perform your manufacturing industry audits. The knowledge delivered by this Alert can assist you in achieving a more comprehensive understanding of the business and economic environment in which your clients operate—an understanding that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. Also, this Alert delivers information about emerging practice issues, and information about current accounting, auditing, and regulatory developments.

.02 If you understand what is happening in the manufacturing industry, and if you can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

.03 This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

Industry and Economic Developments

.04 For a complete overview of the current economic environment in the United States, see the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010].

The U.S. Business Environment

.05 The current economic recovery is in its early stages and sustainable momentum has yet to fully emerge. Even though exports are beginning to recover from their second worst year in half a century, and business investment has stopped its steep decline, these positive signs have been eclipsed by a drop-off in consumer confidence, which could have a substantial ripple effect on the economy, resulting in decreased corporate earnings, increased layoffs, and further depression of the stock market.

.06 One of the biggest impediments to economic expansion is the difficulty companies are having in obtaining credit. Small and medium-size businesses continue to find it difficult to obtain the credit they need for basic capital investment and working capital. The great majority of companies are too small to borrow in the public markets. As of August 2002, bank business loans had declined steadily for 73 weeks to the lowest level since November 1999, and the Comptroller of the Currency reports that more than 60 percent of the largest banks continue to tighten loan standards. To be sure, the short-term economic picture looks unclear.

.07 Still, the financial underpinnings of the U.S. economy remain strong. Inflation is contained, interest rates are at a 40-year low, taxes have been lowered, and energy prices have fallen. New orders for nondefense capital goods, a good gauge for overall business investment, have risen during 2002. So, the U.S. economy continues to experience weak to mild growth, while the future appears uncertain and might worsen before it achieves stability and further growth.

General Industry Trends and Conditions

.08 After a number of years during which high-tech companies dominated the marketplace and drove the economic expansion, traditional manufacturers once again are emerging as a stabilizing force in the U.S. economy. According to the Commerce Department, inventory restocking contributed to more than half of the growth in the gross domestic product (GDP) in the first quarter of 2002, and all of GDP growth in the second quarter. Because technology has helped to increase productivity, manufacturers have cut costs while maintaining high levels of production. Excess capacity has abated and inventories are being rebuilt, industrial production is rising, profits among manufacturers are stabilizing, and new capital expenditures are being made.

.09 Nevertheless, manufacturing activity remains weak and is being adversely affected by poor foreign markets, lower automobile sales, and a lack of strong capital spending by most companies.

.10 Even though last years' September 11 attacks on America were a shock to the business environment, certain manufacturers have seen a substantial increase in business. For example, manufacturers of mainframe computers and some computer storage equipment have seen more business, as companies strengthen backup systems and disaster-recovery plans. The various sectors of the manufacturing industry will all be affected by the current economic events, but each sector is likely to be affected differently.

Manufacturers' Response to the Weak Economy

Inventory

.11 In response to current economic conditions, many manufacturers are tightly managing inventories and costs. As a result of recent sluggish consumer spending, retailers have bought less merchandise and also have reduced spending on equipment and software. These reductions have had a direct impact on the manufacturers of such goods. See the "Audit and Accounting Issues Arising From Current Risks" section of this Alert for in-depth discussions about inventory.

Risk Management

.12 Short product life cycles are a fundamental characteristic of numerous sectors within the manufacturing industry. For example, the life cycle of a desktop PC is thought to be two years or less, and it is estimated that up to 50 percent of profits for PCs and related products are generated in the first three to six months of sales. Those manufacturers with such short product life cycles face the risk of inventory obsolescence. See the "Inventory Valuation" section later in this Alert for a discussion of this issue.

.13 Manufacturers may enter into hedging transactions to protect themselves from fluctuating prices of the components used in the production of their products. As a result, those manufacturers may need to consider Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

.14 The use of debt extinguishment also has become part of the risk management strategy of many companies. Those manufacturing clients that have employed such strategies will need to consider FASB Statement No. 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*.

Bankruptcies and Going Concern

.15 The volatile economic environment has resulted in difficult times, and even bankruptcies, for some manufacturers. Auditors should be aware of their responsibility to evaluate whether there is substantial doubt about a manufacturer'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. See the "Evaluating Going Concern" section of this Alert.

Plant Closings

.16 The cost cutting and restructuring undertaken by many manufacturers have led to a number of plant closings. In these circumstances, auditors should consider whether management has accounted for these plant closings and restructurings appropriately. See the “Plant Closings, Restructuring Charges, and Asset Impairments” and the “How Employee Layoffs Might Affect Audit Engagements” sections of this Alert for a discussion of a number of the accounting and auditing issues that result when a manufacturing entity closes plant locations.

Electronic Commerce

.17 Manufacturers today operate in a highly competitive, dynamic marketplace. To meet the increasing demands for speed and customer responsiveness and to optimize business opportunities, manufacturers are transforming their manufacturing, procurement, and other operations into e-businesses. In the near term, manufacturers may see suppliers, plants, warehouses, distribution centers, sales channels, business partners, and customers all interconnected by advanced e-business applications. The auditor should be aware of the effect that e-commerce has on a manufacturing entity’s internal control as he or she plans and performs the audit. See the “Going Electronic—Consideration of Internal Control” section of this Alert for a further discussion of these matters.

Help Desk—See the lengthy discussion of the current e-business economic environment in the AICPA Audit Risk Alert *E-Business Industry Developments—2002/03* [AAM section 8210]. That Alert also contains detailed discussions about the unique accounting and auditing concerns prevalent in an e-business environment. To order, call the AICPA Order Department at (888) 777-7077 or go to www.cpa2biz.com.

Regulatory and Legislative Issues

The Sarbanes-Oxley Act of 2002

.18 On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. The Act dramatically affects the accounting profession and impacts not just the largest accounting firms, but any CPA actively working as an auditor of, or for, a publicly traded company or any CPA working in the financial management area of a public company. The Act contains some of the most far-reaching changes that Congress has ever introduced into the business world. Although most of the provisions of this legislation are specific to auditors of public companies, even practitioners not performing audits may be affected by the Act. Therefore, all CPA firms should become familiar with the provisions of the Act.

.19 Read the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] for a detailed description of the provisions of the Act and a description of recent and forthcoming rules and regulations implementing the Act.

High-Tech Survival Act

.20 Legislation titled the High-Tech Survival Act has been introduced in Congress. This bill seeks to provide economic relief to businesses in two ways:

1. The bill proposes a two-year recovery period—from the current five-year period—for depreciation of computers and other manufacturing equipment. These include any wireless telecommunications equipment, any advanced services equipment, any network or network system equipment, and certain computer software.
2. The bill proposes shortening the depreciation recovery period for spectrum license fees from 15 years to 7 years.

Most individuals in the high-tech manufacturing industry believe it is imperative that something be done to immediately stimulate our economy and ensure that Americans continue to support the nation's economic growth through these difficult times. According to industry observers, the High-Tech Survival Act will provide much-needed relief to businesses, big and small, and to the high-tech manufacturing industry, in particular.

Audit and Accounting Issues Arising From Current Risks

.21 The proper planning and execution of an audit have always required the auditor to have an understanding of the industry and the nature of the client's business. For most audit firms, this in-depth understanding means that the most experienced partners and managers must become involved early and often in the audit process. In today's manufacturing environment, the auditor's judgment, knowledge, and experience are even more important than they were in the past.

General Consideration of Fraud

.22 The recent wave of accounting scandals at major U.S. corporations should heighten the auditor's awareness of the possibility of fraud in their financial statement audits. In September 2002, the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), which gives auditors expanded guidance for detecting material fraud. SAS No. 99 supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1 AU sec. 316A), and even though the new standard may carry the same title as SAS No. 82, auditors need to recognize that it is clearly more far-reaching than its predecessor. SAS No. 99 should substantially change auditor performance, thereby improving the likelihood that auditors will detect material misstatements due to fraud. See the section of this Alert titled "New Auditing, Attestation, and Quality Control Pronouncements and Other Guidance" for more detailed information about SAS No. 99. SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.

.23 SAS No. 99 is extremely comprehensive and touches on many elements of the audit process. It cannot be reduced to a checklist or form. The effective implementation of SAS No. 99 will require auditors to *audit smarter* and think more creatively when they audit. Engagement teams that plan to implement the new standard by obtaining an updated version of a generic audit program will be doing themselves and their clients an injustice. The effective implementation of SAS No. 99 will force you to rethink how you plan and perform your audits. To help practitioners implement SAS No. 99, the AICPA has developed a Practice Aid titled *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide*.

Revenue Recognition

.24 Revenue recognition continues to pose significant audit risk to auditors. In this challenging economic and business environment, management may be under great pressure to improve financial results. Because revenue is an easy target to boost profits, the auditor should be aware of the potential for inflated revenue, and may need to pay particular attention to revenue recognition issues. Moreover, SAS No. 99 includes a presumption that improper revenue recognition is a fraud risk.

Evaluating Accounting Estimates Relevant to Revenue Recognition

.25 The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. The evaluation of estimates is always an area of auditing concern because the measurement of estimates is inherently uncertain and depends on the outcome of future events. SAS No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342.10), sets forth guidance for auditing estimates. Refer to the "Collectibility of Receivables" section of this Alert for a description of those guidelines.

.26 Sales returns are a key estimate in a manufacturing entity and they are a key element in proper revenue recognition. When a sales transaction includes a right of return, FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*, lists six conditions, *all* of which must be met to recognize revenue at the time of sale. Those conditions are:

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 the 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.
5. The seller does not have significant obligations for future performance to directly bring about the resale of the product by the buyer.
6. The amount of future returns can be reasonably estimated.

If all of the preceding conditions are not met, sales recognition should be postponed until the right of return substantially expires or until such time as the conditions are met.

.27 The most subjective of those conditions is the requirement that the amount of future returns can be reasonably estimated. FASB Statement No. 48 provides specific guidance on a number of factors that may impair, but not necessarily preclude, the ability to make a reasonable estimate. These are:

- The susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand.
- Relatively long periods in which a particular product may be returned.
- Absence of historical experience with similar types of sales of similar products, or inability to apply such experience because of changing circumstances, for example, changes in the selling enterprise's marketing policies or relationships with its customers.
- Absence of a large volume of relatively homogeneous transactions.

If revenue is recognized at the time of sale because these conditions are met, FASB Statement No. 48 requires that the costs or losses that may be expected in connection with returns must be accrued in accordance with FASB Statement No. 5, *Accounting for Contingencies*. The sales revenue and cost of sales reported in the income statement should be reduced to reflect estimated returns.

Help Desk—For additional guidance, the auditor should refer to the AICPA Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk) and the AICPA Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk). To order, call the AICPA at (888) 777-7077 or go to www.cpa2biz.com.

Valuable SEC Guidance

.28 Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, summarizes the Securities and Exchange Commission (SEC) staff's views in applying generally accepted accounting principles (GAAP) to selected revenue recognition issues. SAB No. 101 reflects the basic principles of revenue recognition in GAAP and does not supersede any existing authoritative literature. Accordingly, although SAB No. 101 is directed specifically to transactions of public companies, management and auditors of nonpublic companies may find the guidance helpful in analyzing revenue recognition matters.

.29 SAB No. 101 presents various fact patterns, questions, and interpretive responses concerning whether the following criteria of revenue recognition are met:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been rendered.
- The seller's price to the buyer is fixed or determinable.
- Collectibility is reasonably assured.

.30 Another SEC publication, *SAB No. 101: Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers*, addresses recurring questions from preparers, auditors, and analysts about how to apply the guidance in SAB No. 101 to particular transactions.

Essential Auditing and Accounting Guidance

.31 The AICPA Audit Guide *Auditing Revenue in Certain Industries* assists auditors in auditing financial statement assertions about revenue. The auditor can look to this Guide for descriptions and explanations of auditing standards, procedures, and practices as they relate to auditing assertions about revenue in the manufacturing industry. This Guide:

- Discusses the responsibilities of management, boards of directors, and audit committees for reliable financial reporting.
- Summarizes key accounting guidance regarding whether and when revenue should be recognized in accordance with GAAP.
- Identifies circumstances and transactions that may signal improper revenue recognition.
- Summarizes key aspects of the auditor's responsibility to plan and perform an audit under generally accepted auditing standards (GAAS).
- Describes procedures that the auditor may find effective in limiting audit risk arising from improper revenue recognition.

In addition to that Guide, chapter 6 of the AICPA Practice Aid *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (product no. 006613) provides in-depth guidance on auditing revenue recognition, and also discusses relevant accounting issues.

Evaluating Going Concern

.32 Generally, the manufacturing industry as a whole is sensitive to negative changes in economic conditions, such as reductions in personal income, layoffs, higher unemployment levels, and decreases in consumer confidence. In addition, many manufacturers have in recent years experienced intense competition, recurring operating losses, and negative cash flows. Many small and medium-size businesses that do not have access to the public markets are finding it difficult to obtain the credit they need for basic capital investment and working capital. Accordingly, the auditor should be alert to general economic and other conditions and events that, when considered in the aggregate, indicate there could be substantial doubt about a manufacturing entity's ability to continue as a going concern. More specifically, the auditor should consider the client's short-term cash requirements and cash-generating ability. These two issues alone are critical enough for survival to prompt auditors to consider whether clients that require additional cash in the next 12 months to maintain operations can continue as going concerns.

.33 In general, conditions and events that might indicate caution about going-concern issues 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 challenges, such as substantial dependence on the success of a particular product line or service; or (4) external matters, such as

disaster occurrences, pending legal proceedings, or loss of a principal supplier. Also, an entity's excessive and unusual reliance on external financing, rather than on money generated from the company's own operations, may indicate a going-concern issue.

Auditor's Responsibilities Related to a Going-Concern Issue

.34 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. 341.02 and .03b), as amended. That statement provides guidance about conducting an audit of financial statements in accordance with GAAS to evaluate whether there is substantial doubt about a client's ability to continue as a going concern for a reasonable period of time.

.35 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, or the ability to remain a going concern, 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. The results of auditing procedures designed and performed to achieve other audit objectives should be sufficient for that purpose.

.36 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 management plans can mitigate existing conditions and events and whether those plans can be effectively implemented. If the auditor obtains sufficient competent evidential matter to alleviate doubts about going-concern issues, he or she should give consideration to the possible effects on the financial statements and the adequacy of the related disclosures. If, however, after considering identified conditions and events, along with management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern remains, the audit report should include an explanatory paragraph to reflect that conclusion. In these circumstances, refer to the specific guidance set forth under SAS No. 59.

Documentation Requirements

.37 SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), amends SAS No. 59 to require the auditor to document:

- The conditions or events that led him or her to believe that there is substantial doubt about the entity's ability to continue as a going concern.
- The work performed in connection with the auditor's evaluation of management's plans.
- The auditor's conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated.
- The consideration and effect of that conclusion on the financial statements, disclosures, and the audit report.

Manufacturers in Bankruptcy Reorganization

.38 For those manufacturers that are under bankruptcy reorganization pursuant to chapter 11 of the Bankruptcy Code, or are emerging from it, the auditor should consider whether the company is following the accounting guidance of Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*. Manufacturers that filed for bankruptcy may have impairments that need to be recorded before fresh-start accounting under SOP 90-7.

Inventory and Analytical Procedures

Just-in-Time and Total Quality Management Considerations

.39 The auditor must obtain sufficient competent evidential matter to provide a reasonable basis for the audit opinion. With the conversion by many manufacturers to the just-in-time (JIT) and total quality management (TQM) concepts, it may be necessary to reevaluate the auditor's approach to the audit of inventory.

.40 The focus of JIT/TQM is on the process rather than the product, as in traditional manufacturing environments. Parts are bundled and prepared by process cells rather than by products; production costs are charged to the process cells for the daily production rather than to jobs or lots. As a result, work-in-process (WIP) inventory counts are not as accurate as those in traditional manufacturing environments; however, in a JIT system the amount of inventory in process likely will not be material. This is a substantial change from traditional manufacturers, where WIP could be the most significant current asset. In addition, in a JIT setting, work orders do not serve as the primary documentary evidence for tracking costs, as they do in a traditional manufacturing environment.

.41 For manufacturers that have adopted the JIT production process, more extensive analytical review procedures on the relationships between production throughput, total cycle time, sales volume, and manufacturing costs may be necessary to obtain sufficient competent evidential matter, to compensate for the reduced paper audit trail. According to SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329.02), as amended, analytical procedures are an important part of the audit process and consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

.42 Auditors should be aware of the need to have analytical procedures performed by staff with sufficient industry expertise to properly evaluate the results. In performing analytical procedures, auditors compare 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, and Standard & Poor's)

Documenting Analytical Procedures

.43 SAS No. 96, *Audit Documentation*, amended SAS No. 56 to require auditors to document the factors they considered in developing the expectation for a substantive analytical procedure. Auditors also must document the expectation, if it is not apparent from the documentation of the work that they performed. The auditor also should document (1) the results of his or her comparison of that expectation to the recorded amounts or ratios that he or she developed from recorded amounts and (2) any additional auditing procedures he or she performed in response to significant unexpected differences arising from the analytical procedures as well as the results of such additional procedures.

Key Ratios to Help Analyze Inventory

.44 The following gives a brief description of some of the ratios commonly used in a manufacturing environment for inventory valuation:

- The *gross profit ratio* indicates whether profit goals will be met and whether there are unusual variances in the cost of sales and inventory, and is computed as gross margin divided by net sales.
- The *finished goods turnover ratio* indicates how well inventory is managed and whether sales problems exist, for example, over- or understocking. It can be expressed in terms of a rate or days. If expressed as a rate, the finished goods turnover ratio is computed as the cost of goods sold divided by average finished goods inventory. If expressed in days, it is calculated as average finished goods inventory divided by the cost of sales, times the number of days in the period.
- The *raw materials turnover ratio* indicates the number of times raw material inventory was “used” on the average during the period. It is calculated as the cost of raw materials used divided by the average raw materials inventory.
- The *days’ supply in inventory ratio* provides an estimate of the number of days’ supply of inventory the client has on hand. It indicates the general condition of over- or understocking, and is calculated as number of days in the period divided by the inventory turnover, as computed in the second bullet in this list.
- The *inventory ratio* is calculated as sales divided by inventory. A low ratio of sales to inventory may indicate overstocking, slow-moving goods, overstatement of sales, or a lack of balance in inventory.
- The *obsolescence reserve as a percentage of inventory ratio* is calculated as the obsolescence reserve divided by average inventory. It indicates the general adequacy of the obsolescence reserve.

Help Desk—For additional guidance, the auditor should refer to the AICPA Audit Guide *Analytical Procedures* (product no. 012551kk). To order, call the AICPA at (888) 777-7077 or go to www.cpa2biz.com.

Inventory Valuation

.45 The primary literature on inventory accounting is Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*. Chapter 4 of ARB No. 43 states:

[I]n keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories shall be stated at cost . . . A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. If the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes, a loss [shall] be reflected as a charge against the revenues of the period in which it occurs. The measurement of such losses shall be accomplished by applying the rule of pricing inventories at cost or market, whichever is lower.

Whether inventory is properly stated at lower of cost or market can be a very significant issue for many manufacturers due to advances in technology and the ever-changing marketplace. Examples of factors that may affect inventory pricing include:

- Changes in a product’s design that may have an adverse effect 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, which may decrease salability of a client’s products.
- Changes in the products promoted in the industry as a whole, such as a shift from analog to digital technology, which may affect salability.
- Changes in foreign economies that could result in such situations as slowdown of sales to that region or lower-priced imports from that region.

- Changes in technology to produce products that can give competitors a selling-price advantage.
- Changes in regulations that could affect the competitive environment.
- The entity's own product changes that may not be well researched due to the pressure to introduce new products quickly, resulting in poor sales or high returns.

.46 A highly competitive environment and the rapid technological advancement in some segments contribute to the common problem of inventory obsolescence in the manufacturing industry. As such, the auditor should consider whether the carrying amount of inventories is appropriate.

Factors to Consider in Evaluating Inventory Valuation

.47 The auditor may consider 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 that could significantly reduce their value
- Inventory valuation ratios, such as gross profit ratios, inventory turnover, obsolescence reserves as a percentage of inventory, and days' supply in inventory (The "Inventory and Analytical Procedures" section in this Alert describes some of the ratios commonly used in a manufacturing environment to evaluate the reasonableness of inventory valuation and to help identify the existence of obsolete 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 producing inventory
- Levels of product returns
- Pricing trends for the type of products sold by the client
- Changes in standards used by the industry

These are not the only issues of importance to consider. The auditor may need to address other issues, including the client's taking of physical inventories. Consider the guidance set forth in SAS No. 1, section 331, *Inventories* (AICPA, *Professional Standards*, vol. 1, AU sec. 331.09–.13). Among the issues for consideration are the following:

- When dealing with some difficult types of inventory, such as chemicals used in a process, the auditor may need to take samples for outside analysis. The work of a specialist may also be needed, and in this case the auditor should follow the guidance set forth in SAS No. 73, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1, AU sec. 336).
- The extent to which raw materials have been converted to work-in-process will need to be determined to assess the value of the work-in-process.
- Indications of old or neglected materials or finished goods need to be considered.

Tests to Help Identify Obsolete Inventory

.48 The appendix to SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.26), lists the following substantive tests the auditor might want to consider in identifying slow-moving, excess, defective, and obsolete items included in inventories:

1. Examine an analysis of inventory turnover.
2. Review industry experience and trends.
3. Analytically compare the relationship of inventory balances to anticipated sales volume. (The "Inventory and Analytical Procedures" section in this Alert describes some of the ratios commonly used in a manufacturing environment to evaluate the reasonableness of inventory valuation and to help identify the existence of obsolete inventory.)
4. Tour the facility.
5. Inquire of production, sales, and other relevant personnel concerning possible excess or obsolete items.

When significant excess or obsolete inventories exist, it may be appropriate to include the matter in the management representation letter. SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333.17), as amended, provides the following illustrative example of such a representation: "Provision has been made to reduce excess or obsolete inventories to their estimated net realizable value."

Fraudulent Financial Reporting of Inventory

.49 As the economy remains sluggish and management is under pressure to provide positive financial results, companies may be more prone to inventory fraud. Auditors who are familiar with common methods for fraudulent inventory manipulations will be in a much better position to identify them.

.50 There are many ways management can attempt to manipulate inventory. Those clients may use a combination of several methods, including fictitious inventory, the manipulation of inventory counts, the nonrecording of purchases, and fraudulent inventory capitalization. All these schemes have the same goal of illegally boosting inventory values.

.51 SAS No. 99 provides guidance to help auditors fulfill their responsibilities to detect material misstatements caused by fraud. SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible. If SAS No. 99 has not yet been adopted, the provisions of SAS No. 82 should be followed.

Fraudulent Asset Valuations

.52 The misstatement of asset valuations is the most common form of inventory fraud. Inventory overstatement makes up the majority of asset valuation frauds and is the focus of this section.

.53 The valuation of inventory involves two separate elements: quantity and price. Goods are constantly being bought, sold, manufactured, and transferred among locations. Figuring the unit cost of inventory can be problematic; cost accounting methods and inventory valuation methods can routinely make a material difference in what the final inventory is worth. As a result, the complex inventory account is an attractive target for fraud.

.54 An obvious way to increase inventory value is to create various records for items that do not exist, including unsupported journal entries, inflated inventory count sheets, bogus shipping and receiving reports, and fake purchase orders. Because it may be difficult for the auditor to spot such phony documents, he or she may use other means to substantiate the existence and value of inventory.

Auditing Procedures

.55 During the observation of the physical inventory, the auditor should validate the inventory quantity by test counting. Because the auditor relies heavily on observation of the client's physical inventory count, documenting his or her test counts is important. Even when the auditor observes the physical inventory count and performs and records test counts, inventory fraud can go undetected. The following are examples:

- Management representatives follow the auditor and record the test counts. Thereafter, the client can add phony inventory to the items not tested, in turn falsely increasing the total inventory values.
- Auditors announce in advance when and where they will conduct their test counts. For companies with multiple inventory locations, this advance warning may permit management to conceal shortages at locations that auditors will not visit.
- Sometimes auditors do not take the extra step of examining packaged boxes. To inflate inventory, management may stack empty boxes, or boxes may contain items other than inventory in the warehouse.

.56 *Analytical Procedures.* Auditors can use analytical procedures to help detect inventory overstatements. When analyzing a company's financial statements and accounting records, the auditor can look for the following trends:

- Inventory increasing faster than sales
- Decreasing inventory turnover
- Shipping costs decreasing as a percentage of inventory
- Inventory rising faster than total assets move up
- Falling cost of sales as a percentage of sales
- Cost of goods sold on the books not agreeing with tax returns

The auditor can also examine the cash disbursements subsequent to the end of the audit period. If the auditor finds payments made directly to suppliers that were not recorded in the purchase journal, he or she should investigate further.

.57 *Assessing the Risk of Inventory Fraud.* The auditor may ask the following questions. Many *yes* answers may indicate greater risk of inventory fraud:

- Is the company attempting to obtain financing secured by inventory?
- Has the percentage of inventory to total assets increased over time?
- Has the ratio of cost of sales to total sales decreased over time?
- Have shipping costs fallen compared with total inventory?
- Has inventory turnover slowed over time?
- Have there been significant adjusting entries that have increased the inventory balance?
- After the close of an accounting period, have material reversing entries been made to the inventory account?

New Guidance Available

.58 Chapter 8 of the AICPA Practice Aid *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* addresses the fraudulent financial reporting of inventory. Practitioners will find that guidance useful in planning and performing their audits of inventory balances.

Collectibility of Receivables

.59 The current high levels of bankruptcies in the retail and other industries should cause auditors of manufacturers to more closely evaluate the collectibility of their accounts receivable. 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—a contra-asset account used to bring accounts receivable to their net realizable value. When auditing estimates, auditors should be familiar with SAS No. 57, *Auditing Accounting Estimates*, which provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates used in a client's financial statements. Practitioners also should refer to the section "Revenue Recognition" of this Alert for additional guidance. The guidelines set forth by SAS No. 57 include the following:

- Identify the circumstances that require accounting estimates.
- Consider internal control relating to developing accounting estimates.
- Evaluate the reasonableness of management's estimates.

.60 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 before completion of fieldwork, including returns, chargebacks, and payments by customers.

.61 A review of the aging of the accounts receivable may be performed. This may include testing the reliability of the aging report; reviewing past due accounts on the report, including the number and amounts of such accounts; reviewing the client's prior history in collecting past due balances; reading customer correspondence files and credit reports; and so forth. This may be done with the assistance of the client in obtaining an understanding of how the allowance was developed and determining whether it is reasonable. Testing the reasonableness of the company's estimate of the collectibility of receivables also may be performed by using the following procedures:

1. Obtain publicly available information on major customers to determine their ability to honor outstanding obligations to the company.
2. Investigate unusual credit limits or nonstandard payment terms granted to customers.
3. Test subsequent collections of receivables.

.62 Often, the large number of customer accounts makes it difficult to determine the adequacy of the allowance only by reference to individual accounts. In such cases, a very useful tool in evaluating the allowance for doubtful accounts is the application of analytical procedures. The following are examples of the ratios auditors might use to evaluate collectibility of accounts receivable:

- *Accounts receivable turnover* indicates how well the company collects its receivables and is computed as net credit sales divided by average accounts receivable.
- *Bad debts to net credit sales* indicates whether writeoffs are adequate. It is computed as bad debt expense divided by net credit sales.
- *Allowance for doubtful accounts to accounts receivable* indicates whether the allowance is adequate. It is computed as the allowance for doubtful accounts divided by accounts receivable.

The auditor may also review revenue and receivables transactions and fluctuations after the balance-sheet date for items such as sales, writeoffs, and collections subsequent to year end. This may provide additional information about the collectibility of the accounts receivable and the reasonableness of the allowance account on the balance sheet date.

How Employee Layoffs Might Affect Audit Engagements

.63 Layoffs in the manufacturing industry during the recent recession accounted for 906,000 of the 1.3 million non-farm jobs that were lost. Many manufacturers continue to experience layoffs during this weak economic recovery. The layoff trend is broad based, affecting not only high-tech manufacturers, but also businesses once thought to be relatively safe from changes in the economy; for example, manufacturers of food and consumer products. Healthy companies are also using layoffs as a tool to reduce costs and accumulate earnings as they maneuver through this economic malaise.

.64 If manufacturing clients are experiencing or have experienced layoffs, they will need to properly account for employee-related termination charges, such as severance package charges, restructuring charges, and voluntary separation charges. In addition, management may incur fees for outplacement services offered to their departing employees and bonuses and educational allowances offered to assist employees in contending with the loss of their jobs. Following are some highlights of the accounting literature that may need to be considered.

- FASB Statement No. 146, *Accounting for Costs Associated With Exit or Disposal Activities*, addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies FASB Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." FASB Statement No. 146 requires that a liability for a cost associated with an exit or a disposal activity be recognized when the liability is incurred. The Statement also establishes that fair value is the objective for initial measurement of the liability.
- FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, establishes standards for accounting for curtailments and termination benefits, among other issues. Practitioners should refer to paragraphs 6 through 14 for guidance on curtailments, and paragraphs 15 through 17 for guidance on termination benefits.
- FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, requires recording as a loss the effect of curtailments, for example, termination of employees' services earlier than expected, that may or may not involve closing a facility or discontinuing a segment of a business. Refer to paragraphs 96 through 99 for guidance on how to account for plan curtailments. The Statement also provides guidance on how to measure the effects of termination benefits in paragraphs 101 and 102.
- FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits*, an amendment of FASB Statements No. 5 and No. 43, requires that entities providing postemployment benefits to their former or inactive employees accrue the cost of such benefits. Accrual would occur in accordance with FASB Statement No. 5, *Accounting for Contingencies*, when four conditions are met. Inactive employees include those who have been laid off, regardless of whether they are expected to return to work. Postemployment benefits that can be attributed to layoffs can include salary continuation, supplemental unemployment benefits, severance benefits, job training and counseling, and continuation of benefits, such as health care benefits and life insurance coverage. FASB Statement No. 112 does not require that the amount of postemployment benefits be disclosed. Financial statement disclosure should be made if an obligation for postemployment benefits is not accrued because the amount cannot be reasonably estimated.
- FASB Statement No. 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits*, addresses disclosures only (that is, not measurement or recognition) and standardizes the disclosure

requirements for pensions and other postretirement benefits. Among other disclosures, the Statement requires the disclosure of the amount of any gain or loss recognized due to a settlement or curtailment. Additionally, the cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event are required to be disclosed.

Internal Control Concerns

.65 Significant layoffs can have a serious effect on an entity's internal control and financial reporting and accounting systems. Employees who remain at the company may feel overwhelmed by their workloads, may have insufficient time to complete their tasks completely and accurately, and may be performing too many tasks and functions. With additional workloads and requirements for the performance of added tasks, the company might experience challenges to maintaining an adequate segregation of duties in addition to other experiences affecting internal control.

.66 The auditor may need to consider the possible effects that key unfilled positions can have on internal control. Entities that have experienced strong financial reporting and accounting controls before layoffs could see those controls deteriorate due to the lack of employees and to redefined employee tasks.

.67 These issues related to employee layoffs should be considered when the auditor plans and performs the audit and assesses control risk. Gaps in key positions, and other changes related to reorganization or release of employees, may cause control weaknesses representing reportable conditions that should be communicated to management and the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended.

.68 In addition, SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560), describes matters related to subsequent events. The auditor should use this guidance as he or she inquires of and discusses with management matters involving unusual terminations of participants, such as terminations arising from a sale of a division or layoffs, in addition to other matters.

Plant Closings, Restructuring Charges, and Asset Impairments

.69 In the past few years, economic uncertainty has caused some manufacturers to incur significant nonrecurring charges as they restructure their businesses. The overall weak economy has caused manufacturers to evaluate the performance of certain plants and consider whether it might be necessary to close those plants; many manufacturers have incurred sizable charges related to plant closings. Other related costs may include job reductions, sales of business segments, disposal of assets, asset impairment, and eliminating or combining certain functions or departments in an attempt to reduce the cost structure and spur future profitability and return of capital. Auditors need to address a number of issues concerning business restructurings.

.70 FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, provides the primary guidance on accounting for the impairment of long-lived assets. In general, the accounting for the impairment of long-lived assets depends on whether the asset is to be held and used or held for disposal.

Long-Lived Assets Held and Used

.71 Long-lived assets held and used should be reported at cost, less accumulated depreciation, and should be evaluated for impairment if facts and circumstances indicate that impairment may have occurred. Conditions or events such as the following may indicate a need for assessing the recoverability of the carrying amount of assets:

- A dramatic change in the manner in which an asset is used
- A reduction in the extent to which an asset is used

- Forecasts showing lack of long-term profitability
- A change in the law or business environment
- A substantial drop in the market value of an asset

.72 If events and 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.

.73 Lack of an asset-impairment evaluation system may indicate a material weakness in an entity's internal controls. Further, a lack of documentation generally increases the extent to which the auditor must apply professional judgment in evaluating the adequacy of management's writedowns.

Long-Lived Assets to Be Disposed of by Sale

.74 Long-lived assets to be disposed of by sale (assets for which management has committed to a plan of disposal) should be reported at the lower of the 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.

.75 Some long-lived assets might have previously been subject to Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, but FASB Statement No. 144 amended APB Opinion No. 30. The provisions of FASB Statement No. 144 apply to all long-lived assets. Therefore, gains or losses on disposal of a discontinued operation are no longer measured on a net realizable value basis, and future operating losses are no longer recognized before they occur.

Unusual and Infrequent Items

.76 Unusual or infrequent (but not both) transactions or events are to be presented in the statement of income as separate elements of income from continuing operations, as required by APB Opinion No. 30. The presentation should not imply that the amounts are extraordinary items because they do not meet the criteria of being both infrequent and unusual. Clients may present plant closings on the face of the statement of income as a component of continuing operations, such as "provision for plant closing."

.77 Disclosures stating the effect and nature of the transaction or event can be made in the notes to the financial statements using captions, such as unusual items or nonrecurring items, as well as on the face of the statement of income, as stated above.

Assets to Be Disposed of Other Than by Sale

.78 Assets that are to be abandoned, exchanged for a similar productive asset, or distributed to owners in a spin-off are to be considered as held and used until they are disposed of. If the asset is to be abandoned, the depreciable life is revised in accordance with APB Opinion No. 20, *Accounting Changes*. If the asset is to be exchanged for a similar productive asset or distributed to owners in a spin-off, an impairment loss is to be recognized at the date of exchange or distribution, if the carrying amount of the asset exceeds its fair value at that date.

Inventory Markdowns

.79 If appropriate to the circumstances at the particular client, the auditor should determine 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, as provided in SAB No. 67, *Income Statement Presentation of Restructuring Charges*, has been followed regarding the classification of markdowns associated with a restructuring as a component of cost of goods sold.

Goodwill and Other Intangible Assets

.80 Because there have been numerous combinations of manufacturing companies in recent years, and because goodwill may represent a significant asset on the balance sheets of these combined companies, the auditor should carefully consider whether management has properly complied with the new accounting requirements of FASB Statement No. 142, *Goodwill and Other Intangible Assets*.

.81 FASB Statement No. 142 changes the unit of account for goodwill and takes a very different approach to how to account for goodwill and other intangible assets subsequent to their initial recognition. Specifically, FASB Statement No. 142 changes the subsequent accounting for goodwill and other intangible assets in the following respects:

- FASB Statement No. 142 adopts a more aggregate view of goodwill and bases the accounting for goodwill on the units of the combined entity into which an acquired entity is integrated. Those units are referred to as reporting units.
- APB Opinion No. 17, *Intangible Assets*, presumed that goodwill and all other intangible assets were wasting assets (that is, finite lived). FASB Statement No. 142 does not presume that those assets are wasting assets. Instead, goodwill and other intangible assets that have indefinite useful lives will not be amortized but, rather, will be tested at least annually for impairment.
- FASB Statement No. 142 provides specific guidance for testing goodwill for impairment. The annual test for goodwill impairment uses a two-step process that begins with an estimation of the fair value of a reporting unit. However, if certain criteria are met, the requirement to test goodwill for impairment annually can be satisfied without a remeasurement of the fair value of the reporting unit.

Implementing FASB No. 142 can require extensive valuation judgments and calculations. Auditors need to be aware of this situation and ready to evaluate the new accounting.

Repricing of Employee Stock Options

.82 With the downturn in share prices of many manufacturing companies continuing throughout 2002, the stock options previously granted to many essential employees may now have lost much of their value. To retain these employees, many companies may reprice the options. FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, is an interpretation of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and provides that "if the exercise price of a fixed stock option award is reduced, the award shall be accounted for as variable from the date of the modification to the date the award is exercised, is forfeited, or expires unexercised." The EITF has also addressed the repricing issue in EITF Topic No. D-91, *Application of APB Opinion No. 25, Accounting for Stock Issued to Employees*, and FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation, to an Indirect Repricing of a Stock Option*.

.83 FASB Interpretation No. 44 indicates that any modification or sequence of actions by a grantor to directly or indirectly reduce the exercise price of an option award causes variable accounting for the repriced or replacement award for the remainder of the award's life. The change from a fixed to a variable plan triggers the requirement to record income statement charges (or credits) at each reporting date. So, while the intrinsic

value of the option may be zero at the repricing (or modification) date, from that date until the final exercise (or expiration or forfeiture), the company must report an expense or reversal of that expense even though the options are not vested. This expense is the difference between the fair value of the shares at each balance sheet date and the exercise price.

.84 The change in accounting triggered by repricing requiring compensation to be recorded has no effect on cash flow. However, it may reduce net income and earnings per share. Management should be made aware of the consequences of making any modification to their option plans and outstanding options and the financial statement impact of giving equity instruments to nonemployees.

Going Electronic—Consideration of Internal Control

.85 Many manufacturers are becoming “digital enterprises”—using e-business technologies to connect critical business systems directly to customers, employees, suppliers, and distributors. In addition, the just-in-time and total quality management concepts have significantly changed the operating structure of many manufacturing companies. As a result, manufacturers have adopted new models, systems, and processes as advances in technology and business systems have emerged. Frequently, the paper trail from the old internal control system will not provide adequate evidence about the effectiveness of controls in the new environment.

.86 When clients rely on technology to manage and analyze information, audit strategies change. For example:

- Audit evidence that previously existed in paper form may be only available electronically. Accessing electronic audit evidence may require the auditor to become proficient in the use of data extraction or other audit software tools.
- The design and operation of internal control in a computer environment is much different than in a predominately manual environment.

The auditor should be aware of the audit issues unique to a highly computerized environment. In addition, the auditor should identify the risks of material misstatement that can arise during the transition from a highly manual environment to a more computerized operating environment.

.87 In planning the audit, the auditor must reevaluate attitudes toward internal control and operating policies and determine management’s commitment to maintain or improve internal control in the new manufacturing environment. In addition, the auditor should consider the effect changes in technology or other changes in the client’s business may have on its internal control. The auditor should document the understanding of the entity’s internal control as required by SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended. If the understanding reveals weakness in controls, there may be an increased risk of material misstatements in the financial statements. In such circumstances, SAS No. 96, *Audit Documentation* which supersedes SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339A), requires auditors to document their audit findings or issues that in their judgment are significant (which include those that indicate that (1) the financial statements or disclosures could be materially misstated or (2) auditing procedures need to be significantly modified; and circumstances that cause significant difficulty in applying auditing procedures the auditor considered necessary), actions taken to address them (including any additional evidence obtained), and the basis for the final conclusions reached.

.88 SAS No. 96 contains a list of factors that the auditor should consider in determining the nature and extent of the documentation for a particular audit area or auditing procedure. Additionally, for tests of operating effectiveness of controls, audit documentation is now required to include an identification of items tested. The identification of items tested may be satisfied by indicating the source from which the items were selected and the specific selection criteria.

.89 For further information and guidance on auditing in a paperless environment, see the requirements of SAS No. 80, *Amendment to Statement on Auditing Standards No. 31, Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), and the AICPA Audit Practice Release *Auditing in Common Computer Environment* (product no. 021059kk), which alerts the auditor to the changes that need to be considered in a computer environment.

New Auditing, Attestation, and Quality Control Pronouncements and Other Guidance

.90 Presented below is a list of auditing, attestation, and quality control pronouncements, guides, and other guidance issued since the publication of last year's Alert. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 95	<i>Generally Accepted Auditing Standards</i>
SAS No. 96	<i>Audit Documentation</i>
SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i>
SAS No. 100	<i>Interim Financial Information</i>
SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>
SSAE No. 11	<i>Attest Documentation</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i>
SQCS No. 6	<i>Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice</i>
Audit Guide	<i>Service Organizations: Applying SAS No. 70, as Amended</i>
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i>
Audit Interpretation No. 4 of SAS No. 70	"Responsibilities of Service Organizations and Service Auditors With Respect to Forward-Looking Information in a Service Organization's Description of Controls"
Audit Interpretation No. 5 of SAS No. 70	"Statements About the Risk of Projecting Evaluations of the Effectiveness of Controls to Future Periods"
Audit Interpretation No. 14 of SAS No. 58	"Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing"
Audit Interpretation No. 12 of SAS No. 1, section 420	"The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Change in the Year of Adoption"
Audit Interpretation No. 15 of SAS No. 58	"Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations"

(continued)

Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Practice Alert 02-1	<i>Communications With the Securities and Exchange Commission</i>
Practice Alert 02-2	<i>Use of Specialists</i>
Practice Alert 02-3	<i>Reauditing Financial Statements</i>
Practice Aid	<i>Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide</i>
Practice Aid	<i>New Standards, New Services: Implementing the Attestation Standards</i>
Practice Aid	<i>Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users</i>

.91 See the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] for a brief description of these new pronouncements and other publications. Given the significance of SAS No. 99, a description of its requirements is presented below.

.92 The following summary is for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*

.93 SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316A) and amends SAS No. 1, section 230, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230), and SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333). The Statement does not change the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02). However, SAS No. 99 establishes standards and provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.

.94 The following is an overview of the content of SAS No. 99:

- *Description and characteristics of fraud.*
- *The importance of exercising professional skepticism.* This section discusses the need for auditors to exercise professional skepticism when considering the possibility that a material misstatement due to fraud could be present.
- *Discussion among engagement personnel regarding the risks of material misstatement due to fraud.* This section requires, as part of planning the audit, that there be a discussion among the audit team members to (1) consider how and where the entity's financial statements might be susceptible to material misstatement due to fraud and (2) reinforce the importance of adopting an appropriate mindset of professional skepticism.
- *Obtaining the information needed to identify the risks of material misstatement due to fraud.* This section requires the auditor to gather the information necessary to identify the risks of material misstatement due to fraud, by:
 1. Inquiries of management and others within the entity about the risks of fraud.
 2. Considering the results of the analytical procedures performed in planning the audit.

3. Considering fraud risk factors.
 4. Considering certain other information.
- *Identifying risks that may result in a material misstatement due to fraud.* This section requires the auditor to use the information gathered above to identify risks that may result in a material misstatement due to fraud.
 - *Assessing the identified risks after taking into account an evaluation of the entity's programs and controls.* This section requires the auditor to evaluate the entity's programs and controls that address the identified risks of material misstatement due to fraud, and to assess the risks taking into account this evaluation.
 - *Responding to the results of the assessment.* This section emphasizes that the auditor's response to the risk of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating audit evidence. The section requires the auditor to respond to the results of the risk assessment in three ways:
 1. A response that has an overall effect on how the audit is conducted, that is, a response involving more general considerations apart from the specific procedures otherwise planned
 2. A response to identified risks that involves the nature, timing, and extent of the auditing procedures to be performed
 3. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls
 - *Evaluating audit evidence.* This section requires the auditor to assess the risks of material misstatement due to fraud throughout the audit and to evaluate, at the completion of the audit, whether the accumulated results of auditing procedures and other observations affect the assessment. It also requires the auditor to consider whether identified misstatements may be indicative of fraud and, if so, directs the auditor to evaluate their implications.
 - *Communicating about fraud to management, the audit committee, and others.* This section provides guidance regarding the auditor's communications about fraud to management, the audit committee, and others.
 - *Documenting the auditor's consideration of fraud.* This section describes related documentation requirements.

.95 In addition, SAS No. 99 includes an amendment to SAS No. 85, *Management Representations* (AU sec. 333.06 and Appendix A), because SAS No. 99 requires the auditor to make inquiries of management about fraud and risk of fraud. In support of and consistent with these inquiries, the amendment revises the guidance for management representations about fraud currently found in SAS No. 85, paragraph 6(h), and Appendix A.

.96 SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002. Early application of the provisions of SAS No. 99 is permissible.

Implementation Guide Available

.97 The AICPA has developed a Practice Aid titled *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* to help implement SAS No. 99.

New Accounting Pronouncements and Other Guidance

.98 Presented below is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing

of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated with Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions</i>
FASB Interpretation No. 45	<i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i>
SOP 01-5	<i>Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</i>
SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i>
Technical Practice Aids	<i>Software Revenue Recognition</i>
Questions & Answers	<i>FASB Statement No. 87, Employers' Accounting for Pensions</i>

.99 See the AICPA general *Audit Risk Alert—2002/03* [AAM section 8010] for a brief description of these new pronouncements and other publications. Given its relevance to the current manufacturing industry environment, a description of FASB Statement No. 146 is presented below.

.100 The following summary is for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard.

FASB Statement No. 146, Accounting for Costs Associated With Exit or Disposal Activities

.101 This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)."

.102 This Statement requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred. The Board concluded in this Statement that an entity's commitment to a plan, by itself, does not create a present obligation to others that meets the definition of a liability. Therefore, this Statement eliminates the definition and requirements for recognition of exit costs in EITF Issue No. 94-3. This Statement also establishes that fair value is the objective for initial measurement of the liability. Refer to the Statement for effective date and transition information.

On the Horizon

.103 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented below is brief information about some ongoing projects that may be relevant to your engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.104 The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed below. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body**Web Site**AICPA Auditing
Standards Board (ASB)www.aicpa.org/members/div/auditstd/drafts.htmAICPA Accounting
Standards Executive
Committee (AcSEC)www.aicpa.org/members/div/acctstd/edo/index.htmFinancial Accounting
Standards Board (FASB)www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.htmlProfessional Ethics
Executive Committee
(PEEC)www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA’s standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate “exposure draft e-mail list” in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if known, your membership and subscriber number in the message.

Auditing Pipeline

New Framework for the Audit Process

.105 The ASB has exposed a suite of seven proposed SASs relating to the auditor’s risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits. The primary objective of the proposed SASs is to enhance the auditor’s application of the audit risk model in practice by requiring:

- A more in-depth understanding of the entity and its environment, including its internal control, that would better enable the auditor to identify the risks of material misstatement in the financial statements and any steps the entity is taking to mitigate them.
- A more rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- A better linkage between the assessed risks of material misstatement and the nature, timing, and extent of audit procedures performed in response to those risks.

.106 The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*
- *Audit Evidence*, which will supersede SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)
- *Audit Risk and Materiality in Conducting an Audit*, which will supersede SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)
- *Planning and Supervision*, which will supersede section 310, *Appointment of the Independent Auditor*, of SAS No. 1 (AU sec. 310), and SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, which will supersede SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, section 313, *Substantive Tests Prior to the Balance-Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and together with the proposed SAS *Assessing Risks* will supersede SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319)
- *Amendment to SAS No. 39, Audit Sampling*

You should keep abreast of the status of these projects and exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Accounting Pipeline

Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment

.107 Proposed AICPA SOP, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, and proposed FASB Statement, *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment—an amendment of APB Opinions No. 20 and 28 and FASB Statements No. 51 and 67 and a rescission of FASB Statement No. 73*, were issued simultaneously for public comment. Principally, the proposed FASB Statement would amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from its scope the accounting for acquisition, development, and construction costs of real estate developed and used by an entity for subsequent rental activities. The accounting for those costs would be subject to the guidance in the proposed SOP. It also would amend APB Opinion No. 28, *Interim Financial Reporting*, to require that those costs that the proposed SOP would require be expensed as incurred on an annual basis also be expensed as incurred in interim periods.

.108 The proposed SOP addresses accounting and disclosure issues related to determining which costs related to property, plant, and equipment should be capitalized as improvements and which should be charged to expense. The proposed SOP also addresses capitalization of indirect and overhead costs and component accounting for property, plant, and equipment. Final Statements are expected to be issued during the first half of 2003.

Resource Central

Educational courses, Web sites, publications, and other resources available to CPAs

On the Bookshelf

.109 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements.

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit and Accounting Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012551kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2002* (product no. 009894kk)
- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (product no. 006613kk)
- Audit Risk Alert *E-Business Industry Developments—2002/03* [AAM section 8210]

Audit and Accounting Manual

.110 The *Audit and Accounting Manual* (product no. 005131kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs, auditor's reports, checklists, engagement letters, management representation letters, and confirmation letters.

AICPA's reSOURCE Online Accounting and Auditing Literature

.111 Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, *Audit & Accounting Guides* (all 23), *Audit Risk Alerts* (all 19), and *Accounting Trends & Techniques*. To subscribe to this essential service, go to www.cpa2biz.com.

reSOURCE CD-ROM

.112 The AICPA is currently offering a CD-ROM product titled *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 that includes all Guides and the related *Audit 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.

Online CPE

.113 The AICPA offers an online learning tool, *AICPA InfoBytes*. An annual fee (\$95 for members and \$295 for nonmembers) will offer unlimited access to over 1,000 hours of online CPE in one- and two-hour segments. Register today at infobytes.aicpaservices.org.

Member Satisfaction Center

.114 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.115 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.116 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.

Web Sites

AICPA Online and CPA2BIZ

.117 AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the *Audit Risk Alerts*, *Audit and Accounting Guides*, *Professional Standards*, and CPE courses.

Other Helpful Web Sites

.118 Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of the Alert.

.119 This is the first year the AICPA has published a *Manufacturing Industry Developments* Audit Risk Alert. The AICPA expects to continue to publish this Alert 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 e-mail these comments to rdurak@aicpa.org, or write to:

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Harborside Financial Center
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Jersey City, NJ 07311-3881

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Information Sources

Organization	General Information	Fax Services	Internet	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	<i>24 Hour Fax Hotline</i> (201) 938-3787	www.aicpa.org	<i>AcSEC Telephone Line</i> (212) 596-6008
Financial Accounting Standards Board	<i>Order Department</i> P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10		www.fasb.org	<i>Action Alert Telephone Line</i> (203) 847-0700 (ext. 444)
U.S. General Accounting Office	<i>Superintendent of Documents</i> U.S. Government Printing Office Washington, DC 20401-0001 (202) 512-1800	<i>Information Line</i> (202) 512-2250	www.gpo.gov	
Securities and Exchange Commission	<i>Publications Unit</i> 450 Fifth Street, NW Washington, DC 20549-0001 (202) 942-4046 <i>SEC Public Reference Room</i> (202) 942-8078	<i>Information Line</i> (202) 942-8090 (ext. 3) (202) 942-8092 (tty)	www.sec.gov	<i>Information Line</i> (202) 942-8090 (202) 942-8092 (tty)

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AAM Section 9000

Supervision, Review and Report Processing

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

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

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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 No. 1, *Compilation and Review of Financial Statements* (AR section 100), provides the guidance necessary to enable the accountant to comply with the general standards of the profession as explained in paragraph .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. 96, *Audit Documentation* (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.

.07 In addition, the AICPA's 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

* SQCS No. 2 (QC section 20.03), as amended by SQCS No. 6, *Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (QC section 20), to clarify that deficiencies in individual audit, attest, compilation, and review engagements do not, in and of themselves, indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards. By the addition of a footnote, this amendment clarifies the relationship of deficiencies in individual engagements and a firm's system of quality control.

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 audit documentation and reports.

.12 The procedures for reviewing engagement audit documentation and reports is broken into two separate components. The two components consist of (1) detailed review of the audit documentation by the audit senior and (2) the higher-level supervisory review performed by the manager and partner on the engagement.

Review of Audit Documentation

.13 The purpose of the detailed review of the audit documentation 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.

[The next page is 9201.]

AAM Section 9200

In-Charge's 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>
I. General Procedures			
A. .010 General			
1. In planning the audit engagement, were the following matters properly considered?			
a. Matters affecting the environment in which the entity operates, such as accounting practices, economic conditions, government regulations, contractual obligations and technological changes. (SAS No. 22, as amended by SAS No. 77 [AU section 311])	_____	_____	_____
b. Matters affecting the entity's operations, such as legal organization and types of services. (SAS No. 22, as amended by SAS No. 77 [AU section 311])	_____	_____	_____
c. Preliminary judgment about materiality levels for audit purposes. (SAS No. 47 [AU section 312])	_____	_____	_____
d. Consideration of internal control. (SAS No. 55, as amended by SAS No. 78 and SAS No. 94 [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 99 [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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
3. Did the auditor obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements, and determine whether they have been placed in operation? (SAS No. 55, as amended [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 No. 55, as amended [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, and 70, as amended [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, as amended [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. Were procedures performed to obtain information that was used to identify the risks of material misstatement due to fraud, including a discussion among the audit team members about the potential for material misstatement due to fraud?	_____	_____	_____
7. Was a presumption made that there is a risk of material misstatement due to fraud related to revenue recognition in accordance with paragraph 41 of SAS No. 99 (AU section 316.41), and was a proper response to that risk performed? (Ordinarily, there should be a presumption that there is a risk of material misstatement due to related to revenue recognition.)	_____	_____	_____
8. 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 [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])	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____
9. 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 characteristics of the population?	_____	_____	_____
b. Was the sample selected in such a way that it could be expected to be representative of the population?	_____	_____	_____
c. Were the results of the sample evaluated as to their effect on the nature, timing, and extent of planned substantive procedures?	_____	_____	_____
d. Was appropriate consideration given, in evaluating the sample, to items for which the planned test or appropriate alternative procedure could not be performed, for example, because the documentation was missing?	_____	_____	_____
e. Was documentation of the foregoing considerations in accordance with firm policy?	_____	_____	_____
10. If statistical or nonstatistical sampling was used for substantive tests of details (SAS No. 39 [AU section 350]):			
a. Was appropriate consideration given, in planning the sampling application, to the relationship of the sample to the audit objective, preliminary judgments about materiality levels, auditor's allowable risk of incorrect acceptance, and characteristics of the population?	_____	_____	_____
b. Was the sample selected in such a way that it could be expected to be representative of the population?	_____	_____	_____
c. Were the misstatement results of the sample projected to the items from which the sample was selected?	_____	_____	_____
d. Was appropriate consideration given, in evaluating the sample, to items for which the planned substantive tests or appropriate alternative procedures could not be performed?	_____	_____	_____
e. Was appropriate consideration given in the aggregate to projected misstatement results from all audit sampling applications and to all known misstatements from nonsampling applications in evaluating material misstatements in the financial statements?	_____	_____	_____
f. Was documentation of the foregoing considerations in accordance with firm policy?	_____	_____	_____
11. Were the guidelines of SAS No. 56 (AU section 329), followed in the performance of analytical procedures for:			
a. Audit planning?	_____	_____	_____
b. Use as a substantive test?	_____	_____	_____
c. Overall review of the audit?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
12. Was a consideration made whether analytical procedures performed in planning the audit resulted in identifying any unusual or unexpected relationships that should be considered in assessing the risks of material misstatement due to fraud?	_____	_____	_____
13. Was an evaluation made whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud?	_____	_____	_____
14. Did the firm obtain timely and appropriate responses from the auditee's attorney concerning litigation, claims, and assessments? (SAS No. 12 [AU section 337])	_____	_____	_____
15. Have all required engagement forms and documents been completed, signed, and dated?	_____	_____	_____
16. 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?	_____	_____	_____
17. Did the firm obtain a timely appropriate letter of representation from management? (SAS No. 85, as amended [AU section 333])	_____	_____	_____
18. 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])	_____	_____	_____
19. At or near the completion of fieldwork, was an evaluation made whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit?	_____	_____	_____
20. Were errors, fraud, or illegal acts, if any, followed up in accordance with SAS Nos. 99 and 54 (AU sections 316 and 317)?	_____	_____	_____
21. 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])	_____	_____	_____
22. If required by firm policy, was an appropriate engagement letter issued?	_____	_____	_____
23. Were communications of internal control related matters issued in accordance with SAS No. 60 (AU section 325)?	_____	_____	_____
24. 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])	_____	_____	_____
25. 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. 99 [AU section 316])	_____	_____	_____
26. Was the risk of management override of controls addressed?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
27. 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?	_____	_____	_____
28. Was the audit designed to provide reasonable assurance of detecting material misstatements; and when audit test results identified misstatements in the financial statements, was a consideration made whether such misstatements may be indicative of fraud?	_____	_____	_____
29. 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?	_____	_____	_____
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?	_____	_____	_____
30. 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 with an appropriate level of management that is at least one level above those involved and with senior management and the audit committee.	_____	_____	_____
c. An attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and if so, its effect on the financial statements and the auditor's report thereon.	_____	_____	_____
d. If appropriate, suggestions that the client consult with legal counsel on matters concerning questions.	_____	_____	_____
31. 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.	_____	_____	_____
32. 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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____
33. Does the firm's disclosure checklist document that the audit report is properly prepared and that the financial statements are fairly stated?	_____	_____	_____
34. 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])?	_____	_____	_____
35. Was the applicable disclosure checklist completed?	_____	_____	_____

II. Audit Documentation 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?	_____	_____	_____
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. Does the audit documentation indicate that the following were considered?			
a. Restrictions on cash balances.	_____	_____	_____
b. Confirmation of bank credit arrangements such as compensating balances.	_____	_____	_____
c. Review of confirmation responses for indication of related party transactions.	_____	_____	_____
4. Based on the assessed level of control risk, do the substantive tests of cash appear adequate?	_____	_____	_____

B. .030 Receivables

1. Was a summary prepared (or obtained) properly classifying receivables (i.e., notes and accounts receivable; trade; officers, directors, and employees; parent and subsidiary companies; other related party transactions; etc.)?	_____	_____	_____
2. If accounts receivable are not confirmed, has the reason been documented? One of the following is acceptable:			
a. Accounts receivable are immaterial to the financial statements.	_____	_____	_____
b. Use of confirmations would be ineffective.	_____	_____	_____
c. Combined assessed level of inherent and control risk is low (as addressed in the internal control section), and the assessed level, in conjunction with other evidence (analytical procedures or other substantive tests) reduced audit risk to an acceptably low level for applicable financial statement assertions.	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____
10. Was the reasonableness of allowances for doubtful accounts covered in the audit documentation and collectibility of receivables adequately considered?	_____	_____	_____
11. Is there evidence in the audit documentation 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. Does the audit documentation 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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
4. Does the audit documentation 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. Does the audit documentation indicate that a lower of cost or market test was performed (including obsolescence)?	_____	_____	_____
6. If perpetual inventory records are maintained, does the audit documentation 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?	_____	_____	_____
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. Does the audit documentation indicate that steps were performed to determine if any inventory is pledged?	_____	_____	_____
12. Based on the assessed level of control risk, do the substantive tests of inventory appear adequate?	_____	_____	_____
D. .050 Investments			
1. Was a summary schedule prepared (or obtained) and details examined with respect to description, purchase price and data, changes during period, classification of investment income market value, etc., of investments?	_____	_____	_____
2. Were all securities (including stock certificates of subsidiary companies) examined or confirmed?	_____	_____	_____
3. Was investigation made of carrying value and possible cost impairment of investments?	_____	_____	_____
4. Does the audit documentation 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. Does the audit documentation indicate that adequate evidential matter has been accumulated for investments?	_____	_____	_____
7. Based on the assessed level of control risks, do the substantive tests of investments appear adequate?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
E. .060 Prepaid Expenses, Intangible Assets, Deferred Charges, Etc.			
1. Were adequate tests made and/or confirmations received for all material:			
a. Prepaid expenses?	_____	_____	_____
b. Intangible assets?	_____	_____	_____
c. Deferred charges?	_____	_____	_____
d. Other?	_____	_____	_____
2. For prepayments, intangibles, and deferred charges, is there adequate support for deferral and amortization (or lack thereof)?	_____	_____	_____
3. If insurance policies were pledged as collateral or subjected to premium financing, were the related loans properly accounted for?	_____	_____	_____
4. Based on the assessed level of control risk, do the substantive tests of prepaid expenses, intangible assets, deferred charges, etc., appear adequate?	_____	_____	_____
F. .070 Property, Plant, and Equipment			
1. Was a summary schedule prepared (or obtained) to show beginning balances, changes during the period, and ending balances for:			
a. Property, plant, and equipment?	_____	_____	_____
b. Accumulated depreciation?	_____	_____	_____
2. Do tests appear adequate with respect to:			
a. Additions:			
(1) Examination of supporting documents?	_____	_____	_____
(2) Physical inspection?	_____	_____	_____
b. Retirement, etc. (including examination of miscellaneous income, scrap sales, etc.)?	_____	_____	_____
c. The adequacy of current and accumulated provisions for depreciation and depletion?	_____	_____	_____
d. Compliance with control procedures?	_____	_____	_____
e. Status of idle facilities?	_____	_____	_____
3. Do the working papers indicate the presence of liens on property?	_____	_____	_____
4. Were differences between book and tax depreciation reconciled?	_____	_____	_____
5. Was investigation made of possible impairment?	_____	_____	_____
6. Based on the assessed level of control risk, do the substantive tests of property, plant, and equipment appear adequate?	_____	_____	_____
G. .080 Current Liabilities			
1. Were accounts payable adequately tested for propriety?	_____	_____	_____
2. Was an adequate test made of subsequent transactions (i.e., cash disbursements, voucher register entries, vouchers, unpaid invoices, etc.) to determine if any material unrecorded liabilities existed?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____
H. .090 Long-Term Debt			
1. Were confirmations received for significant debt obligations, together with verification of interest rates, repayment period, etc.?	_____	_____	_____
2. Is there evidence that covenants to long-term debt obligations are being complied with?	_____	_____	_____
3. Have leases been examined to determine that capital leases have been properly accounted for?	_____	_____	_____
4. Does the audit documentation include evidence as to compliance with any loan restrictions?	_____	_____	_____
5. Based on the assessed level of control risk, do the substantive tests of long-term debt appear adequate?	_____	_____	_____
I. .100 Deferred Credits			
1. Does the audit documentation indicate that:			
a. The basis of deferring income is reasonable and is on a consistent basis from year to year?	_____	_____	_____
b. Deferrals have been established on a reasonable basis?	_____	_____	_____
2. Based on the assessed level of control risk, do the substantive tests of deferred credits appear adequate?	_____	_____	_____
J. .110 Income Taxes			
1. Were current and deferred tax accrual accounts and related provisions analyzed and reviewed as to adequacy?	_____	_____	_____
2. Does the audit documentation 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?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
4. Based on the assessed level of control risk, do the substantive tests of income taxes appear adequate?	_____	_____	_____
K. .120 Commitments and Contingencies			
1. Does the audit documentation 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.	_____	_____	_____
b. Inspection of contracts, loan agreements, leases, and correspondence from taxing and other governmental agencies, and similar documents.	_____	_____	_____
c. Accumulation and analysis of confirmation responses from banks and lawyers.	_____	_____	_____
d. Inquiry and discussion with management (including management's written representations concerning liabilities, and litigation, claims, and assessments).	_____	_____	_____
e. Inspection of other documents for possible guarantees by the client.	_____	_____	_____
2. Is there indication that procedures were performed to uncover the need for recording or disclosure of events subsequent to the date of the financial statements?	_____	_____	_____
3. Based on the assessed level of control risk, do the substantive tests of commitments and contingencies appear adequate?	_____	_____	_____
L. .130 Capital Accounts			
1. Were changes in capitalization checked to authorizations?	_____	_____	_____
2. Do the working papers indicate that adequate inquiries were made as to:			
a. Stock options?	_____	_____	_____
b. Warrants?	_____	_____	_____
c. Rights?	_____	_____	_____
d. Redemptions?	_____	_____	_____
e. Conversion privileges?	_____	_____	_____
3. Based on the assessed level of control risk, do the substantive tests of capital accounts appear adequate?	_____	_____	_____
M. .140 Income and Expenses			
1. Were tests made of payrolls, including account distribution?	_____	_____	_____
2. With regard to pension and profit sharing plans (including impact of ERISA), do tests of expenses and liabilities appear adequate?	_____	_____	_____
3. Were revenue and expenses for the period compared with those of the preceding period and reviewed for reasonableness with significant fluctuations explained?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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?	_____	_____	_____
N. .150 Other			
1. Were procedures applied to supplementary information in accordance with SAS No. 52 (AU section 558), as applicable?	_____	_____	_____
2. If the work of a specialist was used, was the effect of the specialist's work on the auditor's report considered in accordance with SAS No. 73 (AU section 336)?	_____	_____	_____
3. Were specific procedures applied for determining the existence of related parties and examining identified related party transactions? (SAS No 45 [AU section 334])	_____	_____	_____
4. Was the guidance in SAS No. 47 (AU section 312) regarding audit risk and materiality considered during the planning and performance of the engagement?	_____	_____	_____

This audit engagement has been completed in accordance with professional standards and firm policy.

In-Charge _____ Date _____

Partner _____ Date _____

[The next page is 9241.]

AAM Section 9210

Partner's Engagement Review Program

.01

	<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?	_____	_____	_____
E. .060 Property, Plant, and Equipment			
1. Was a review made to determine that capital expenditures are classified in the proper fund accounts?	_____	_____	_____
F. .070 Liabilities			
1. Were liabilities properly classified as current or long-term and in the proper fund?	_____	_____	_____
2. Were procedures performed to determine whether tax deferred annuity plans are appropriately calculated to conform with GAAP and IRS regulations?	_____	_____	_____
3. Was consideration given to any liabilities (including the effect of any temporary differences) resulting from the federal excise tax on investment income and any federal and state taxes on unrelated business income?	_____	_____	_____
4. Do the tests of interfund borrowings appear adequate with respect to:			
a. Legal restrictions, if any, on such borrowings?	_____	_____	_____
b. Authorization?	_____	_____	_____
c. Classification?	_____	_____	_____
d. Collectibility of amounts due from other funds?	_____	_____	_____
e. Appropriateness of interest accruals and payments?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
G. .080 Deferred Revenue			
1. Do the working papers indicate that consideration was given to whether the basis of deferring revenue is reasonable and consistent with the donors' or grantors' restrictions?	_____	_____	_____
2. Was consideration given to matching requirements, if any?	_____	_____	_____
3. Do the working papers indicate that consideration was given to the appropriateness of the amounts of restricted gifts, grants, bequests, donations, or other income recognized as current revenue or support?	_____	_____	_____
4. Based on the assessed level of control risk, do the substantive tests of deferred revenue appear adequate?	_____	_____	_____
H. .090 Commitments and Contingencies			
1. Did the auditor consider evidence of the entity's activities (such as lobbying) which might cause the entity to lose its tax exempt status or be subject to penalties or taxes?	_____	_____	_____
2. If the entity is a private foundation, as defined by IRC section 509, did the auditor determine whether the entity complied with IRS regulations concerning required distribution of income and prohibited activities?	_____	_____	_____
I. .100 Fund Balance			
1. Where appropriate, were authorizations of changes in reserves and designated balances examined?	_____	_____	_____
2. Do the working papers indicate that there were adequate inquiries, where appropriate, as to proper classification, description and disclosure of components of the fund balance?	_____	_____	_____
3. Do the working papers indicate that fund transfers were properly approved and recorded?	_____	_____	_____
4. If an endowment fund is maintained, do the working papers indicate that fund income is distributed to unrestricted and restricted funds in accordance with donors' stipulations?	_____	_____	_____
5. Based on the assessed level of control risk do the substantive tests of fund balances appear adequate?	_____	_____	_____
J. .110 Revenues, Expenses, Support, and Capital Additions			
1. Were revenues and expenses for the period compared with those of the preceding period and reviewed for reasonableness and were significant fluctuations explained?	_____	_____	_____
2. Was adequate consideration given to:			
a. The entity's revenue recognition policy?	_____	_____	_____
b. Income recognition on transactions where the earnings process is not complete?	_____	_____	_____

	<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?	_____	_____	_____
K. .120 Other			
1. If the entity is affiliated or otherwise financially related to other entities, did the auditor consider the need for combined financial statements or disclosure of the relationship?	_____	_____	_____

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*). Note that the GAO is in the process of revising its auditing standards during 2003. Readers should be alert to these changes and follow the revised requirements as applicable. This section will be updated in the future when the new standards are published and effective.

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:			
<i>a.</i> Adequately evaluated and documented?	_____	_____	_____
<i>b.</i> 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>
I. General Procedures			
A. .010 General			
1. Were banking and other appropriate regulations considered in planning the audit engagement?	_____	_____	_____
II. Working Paper Areas			
A. .020 General			
1. Does the audit documentation 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 investment accounts?	_____	_____	_____
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?			
6. Was the following considered in connection with foreign exchange transactions?			
a. Reasonable assurance that material commitments and contingent liabilities related to international operations have been properly recorded and disclosed.	_____	_____	_____
b. Reasonable assurance that gains and losses from foreign exchange activities of the international department are properly recorded and disclosed.	_____	_____	_____
B. .030 Cash			
1. Were bank accounts in the financial institutions confirmed at the audit date and were reconciling items existing at the balance-sheet date cleared by reference to subsequent statements obtained directly from the financial institutions?	_____	_____	_____
2. Does the audit documentation indicate that the following were considered?	_____	_____	_____
a. Confirmation of liabilities and contingent liabilities to other banks.	_____	_____	_____
b. Proper recording of interest.	_____	_____	_____
3. Does the audit documentation 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. Does the audit documentation reflect whether cash items (checks cashed after close of business, maturing coupons and bonds, returned checks and other items held temporarily pending their liquidation) are properly classified?	_____	_____	_____
C. .040 Investment and Trading Securities			
1. Does the audit documentation 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. Does the audit documentation indicate whether interest and dividend income and security gains and losses were properly recorded?	_____	_____	_____
3. Does the audit documentation indicate whether investments have suffered a permanent reduction in recorded value?	_____	_____	_____
4. Does the audit documentation indicate whether allowances for losses have been provided where necessary?	_____	_____	_____
5. Does the audit documentation indicate whether securities have been properly classified and valued?	_____	_____	_____
6. Does the audit documentation indicate whether amounts for investment securities and the related income, gains and losses are properly presented in the financial statements?	_____	_____	_____
7. Were substantive tests of investment securities adequate based on the assessed level of control risk?	_____	_____	_____
D. .050 Federal Funds and Repurchase/Reverse Repurchase Agreements			
1. Does the audit documentation indicate whether federal funds and repurchase/reverse repurchase agreements represent valid claims against the borrower or obligations to the lender?	_____	_____	_____
2. Does the audit documentation indicate whether amounts shown on the financial statements are properly classified and described?	_____	_____	_____
3. Based on the assessed level of control risk were substantive tests of federal funds and repurchase/reverse repurchase agreements and trading securities adequate?	_____	_____	_____
E. .060 Loans			
1. Was an evaluation of the adequacy of the allowance for loan losses and the selection of loans to be evaluated performed and documented?	_____	_____	_____
2. Did the evaluation in 1 above include:			
a. The bank's lending policies and procedures including its control over loan file documentation and maintenance?	_____	_____	_____
b. Consideration of the qualification of the bank loan officers?	_____	_____	_____

	<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 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?	_____	_____	_____
12. Was consideration given to the use of watch lists, delinquency reports and other sources of potential problems?	_____	_____	_____
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?	_____	_____	_____
17. For loans, was the following considered?			
a. The bank's compliance with its internal control, i.e., approval, reports, documentation, disbursement, and collection.	_____	_____	_____
b. Selection of a sample from all significant loan areas.	_____	_____	_____
c. Did the tests include executed notes, loan applications, financial statements of borrowers, chattels, other credit information and approvals.	_____	_____	_____
d. Confirmation with bank customers.	_____	_____	_____
e. Proper accounting recognition of unearned income, interest income, recognition of acquisition and other fees such as "points".	_____	_____	_____
f. Tests of interest income to average loan balance and yield to interest rates in effect.	_____	_____	_____
g. Testing of related party transactions and conflicts of interest.	_____	_____	_____
h. Testing of the bank's credit card operations.	_____	_____	_____
i. Testing of lease financing operations.	_____	_____	_____
j. Testing of loan participations.	_____	_____	_____
k. Review of underlying collateral.	_____	_____	_____
18. Based on the assessed level of control risk, were substantive tests of loans adequate?	_____	_____	_____
F. .070 Deposits			
1. Does the audit documentation 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?	_____	_____	_____

[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, 20___," then all supporting schedules should be headed that way, rather than "for the year 20___."
- 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	_____	_____	_____	_____	_____

UncoveredWorkpaper copies
(at least two)Extra file copies

Working Paper	_____	_____
Extra	_____	_____

Other Production Instructions:

.13

[illegible]

Signing Reports

.14 After the report has been reviewed, typed, proofread, and corrected, it is usually submitted to a partner for reading and signature.

.15 Some firms do not bind the report until after it is signed. This saves unbinding in case the signing partner orders any revisions. In offices where the reports have been sufficiently and systematically reviewed and referenced before or after typing, they may be submitted to the partner for his signature in final bound form. This saves time and additional handling.

.16 The transmittal letters and addressed envelopes should be submitted to the partner with the reports. This gives him an opportunity to review the mailing directions, so that reports are directed to the proper person.

.17 Report letters are usually signed by a partner using the firm name. Where reproducing equipment is used, a signature on the original is sufficient. It is important to establish rules applying to report signatures since all reports (add correspondence) issued to clients carry with them the reputation, authority, and responsibility of the firm.

Delivery of Completed Work

.18 Audit reports are rightfully considered by clients to be confidential documents. For this reason, care should be taken to address them to a responsible person, usually the treasurer or principal executive, in an envelope clearly marked "confidential." Where there is some question as to the person or persons to whom the report should be delivered, address it to the specific source of authority authorizing the report. In a majority of cases, especially for recurring engagements, the reports are mailed. However, some firms make it a practice to have a partner deliver the report personally and discuss it with the client.

.19 The report should be mailed in envelopes or boxes sturdy enough to withstand the rough treatment they may receive in transit.

.20 Many firms send separate transmittal letters with their reports. The letter should contain no comments on the report because it might be construed as a modification of the opinion on the report. It is advisable to write a letter requesting that a printer's proof be submitted to the accounting firm for review before any printed reports are released by the client to stockholders or the public.

.21 Reports are generally issued only to the client who engaged the services. The unauthorized distribution of a report represents a violation of the confidential relationship between a firm and its client. Firms are sometimes asked by clients to mail copies of their reports directly to third parties. Clients should be discouraged from making such requests. In rare instances, where a firm assumes this added responsibility, distributions are made only upon specific written instruction from the client, and reference to the client's instructions should be included in the transmittal to the third party. Printed annual reports to shareholders, prospectuses, and other reports that are a matter of public record, such as those filed with certain governmental agencies, are obvious exceptions to this rule.

[The next page is 10,001.]

AAM Section 10,000

Accountants' Reports

These examples are for illustrative purposes only. They are included as conveniences for users of this manual who may want points of departure when drafting reports to meet their individual needs. This manual is a nonauthoritative kit of practice aids and accordingly, does not include extensive explanation or discussion of authoritative pronouncements. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate.

These examples illustrate the body of various reports. For comment on addressing and dating of the report, see AAM section 10,100.

Examples which are assembled from illustrative reporting language set forth in Statements on Auditing Standards (SASs) and Statements on Standards for Accounting and Review Services (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, 20XX

- 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, 20XX, except for Note X as to which the date is
April 5, 20XX

- *Level of service.* The level of service performed and the nature of the report are typically outlined in the engagement letter. The letter should be revised for any significant changes from the original understanding with the client, such as, in the event of a step-up or step-down in the level of service.
 - The partner 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 where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility, 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*, SAS No. 93, *Omnibus Statement on Auditing Standards—2000*, and SAS No. 98, *Omnibus Statement on Auditing Standards—2002* (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. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles). 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.

* SAS No. 93, *Omnibus Statement on Auditing Standards—2000*, requires an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards).

- *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 nature of the engagement and the extent and results of testing of supplementary information will determine the firm's responsibility in each circumstance. If a separate report on the supplemental information is issued, the first sentence of that report 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 Issue¹

.32 Occasionally the firm may be requested by a client to furnish additional copies of a previously issued report. Approval of the engagement partner is necessary to reissue a previously issued report. In such situations the engagement partner may prepare a memo stating the reasons for the reissuance and that he or she is not aware of any circumstances occurring since the original report date that would require adjustment to or disclosure in the financial statements.

.33 Use of the original report date removes any implication that records, transactions, or events after that date have been audited or reviewed. Although the auditor has no responsibility to make further investigation or inquiry as to subsequent events, the engagement partner should consider a brief discussion with the client's chief financial or executive officer before reissuing his or her report.

Subsequent Discovery of Facts Existing at Report Date

.34 Although the auditor has no obligation to make any continuing inquiries or perform other procedures after issuing his or her report, the auditor may become aware of information that affects the financial statements upon which he or she has previously reported. When becoming aware of such information, the auditor should determine the reliability of the information and whether such information existed at the date of the report. The engagement partner should make inquiries of client management in this regard.

.35 If the information is reliable and did exist at the date of the report, if the report would have been affected if the information had been known at the report date, and if there are persons relying on the financial statements who would attach importance to the information, the auditor should take action to prevent future reliance on the report. If the engagement partner concludes that action should be taken to prevent future reliance on the report, he or she should advise the client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to the persons known to be, or likely to be, relying on the financial statements and related report. Disclosures should be made in one of the following ways:

¹ The AICPA Auditing Standards Board Auditing Interpretation, *Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report* (AU section 9341.01 and .02), deals with situations where a previously issued report contains a going-concern explanatory paragraph, and the situation that gave rise to the going-concern has been resolved.

- If the effects of subsequent facts can be promptly determined, disclosure should include reissuing revised financial statements and a revised report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor's report.
- If the current financial statements have not been released, appropriate disclosure of the revision of the prior-period financial statements can be included therein.
- When the effects of subsequent facts cannot be readily determined, revisions of financial statements and reports may be delayed. In this case, persons known to be, or likely to be, relying on the financial statements should be notified by the client that the financial statements and related reports should not be relied on, and that revised financial statements and report will be forthcoming.

.36 If the client refuses to make the disclosures discussed above, the auditor should contact legal counsel. He or she should also notify all members of the board of directors of such refusal and that the firm will take the following steps to prevent future reliance on its report:

- Notify the client that the auditor's report must no longer be associated with the financial statements.
- Notify any applicable regulatory agencies that the report should no longer be relied upon.
- Notify each person known to be relying on the financial statements that the report should no longer be relied upon.

.37 If the auditor's investigation of the subsequently discovered information is satisfactory, and he or she has determined that the information is reliable, the notifications in AAM section 10,100.36 should include a description of the effects of the information on the financial statements. If the client has not cooperated and, as a result, the auditor has been unable to conduct a satisfactory investigation, the auditor does not need to indicate the details of the information. Instead, he or she should indicate that the auditor's report must no longer be relied upon nor should the auditor be associated with the financial statements.

[The next page is 10,211.]

AAM Section 10,210

Unqualified Opinions

.010 Auditor's Standard Report—Comparative Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 8, as amended by SAS No. 79 and SAS No. 93 (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, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 8, as amended by SAS No. 79 and SAS No. 93 (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, 20XX. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe that our audit of the balance sheet provides a reasonable basis for our opinion.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 34, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (AU section 508.34).]

Note: If reporting on a single statement (for example, balance sheet only) when other financial statements are also presented, the following paragraph should be added after the opinion paragraph:

Because we were not engaged to audit the statements of income, retained earnings, and cash flows, we did not extend our auditing procedures to enable us to express an opinion on the results of operations and cash flows for the year ended December 31, 20XX. 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, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 74, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (AU section 508.74).]

Practice Tips

- (1) The successor auditor should not name the predecessor auditor in his report; however, the successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with that of the successor auditor.

[Source: SAS No. 58, paragraph 74, footnote 27, as amended by SAS No. 79 (AU section 508.74).]

.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, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of \$_____ and \$_____ as of December 31, 20X2 and 20X1, respectively, and total revenues of \$_____ and \$_____ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 13, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (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, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors whose report dated March 1, 20X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 74, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (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, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, before the restatement described in Note X, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.*

[Signature]

[Date]

[Source: SAS No. 58, paragraph 74, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (AU section 508.74).]

* This paragraph may be added to the report when the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself as to the appropriateness of the restatement adjustment.

.080 Reference to Other Auditors—Prior Year Financial Statements Restated Following a Pooling of Interests*

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated balance sheet of XYZ Company as of December 31, 20X2, 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of XYZ Company as of [at] December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We previously audited and reported upon the consolidated statements of income and cash flows of XYZ Company and subsidiaries for the year ended December 31, 20X1, prior to their restatement for the 20X2 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 20X1 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, 20X1, after restatement for the 20X2 pooling of interests; in our opinion, such consolidated statements have been properly combined on the basis described in Note A of notes to consolidated financial statements.

[Signature]

[Date]

[Source: SAS No. 1, section 543.16, as modified, October 1980, by the Auditing Standards Board, and as amended by SAS No. 64 (AU section 543.16).]

Note: This report is used when the auditor concludes that he or she cannot serve as principal auditor for the restated financial statements.

* Note that FASB Statement No. 141, *Business Combinations*, eliminates the pooling-of-interests method of accounting for a business combination. However, FASB Statement No. 141 does not apply to combinations of two or more not-for-profit organizations, the acquisition of a for-profit business entity by a not-for-profit organization, and combinations of two or more mutual enterprises.

.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, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors who have ceased operations and whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Sources: SAS No. 58, paragraph 74, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (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, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, before the restatement described in Note X, were audited by other auditors who have ceased operations and whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.*

[Signature]

[Date]

[Sources: SAS No. 58, paragraph 74, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (AU section 508.74).]

* This paragraph may be added to the report when the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself as to the appropriateness of the restatement adjustment.

.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, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We have conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were reviewed by other accountants who have ceased operations, and their report thereon, dated March 1, 20X2, stated they were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

[Signature]

[Date]

[Sources: SAS No. 58, paragraph 74, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (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, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosure in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by managements, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were compiled by other accountants who have ceased operations, and their report thereon, dated February 1, 20X2, stated that they did not audit or review those financial statements and, accordingly, express no opinion or any other form of assurance on them.

[Signature]

[Date]

[Sources: SAS No. 58, paragraph 74, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (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, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentations. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 20XX.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 17, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (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, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[Signature]

[Date]

[Source: SAS No. 59, paragraph 13, as amended by SAS No. 77 and with conforming changes due to SAS No. 93 (AU section 341.13).]

Note: In a going-concern explanatory paragraph, the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern.

.110 Liquidation Basis of Accounting—Single Year Financial Statements**Independent Auditor's Report**

Addressee:

We have audited the accompanying statement of net assets in liquidation of X Company as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2. In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X to the financial statements, the stockholders of X Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets in liquidation of X Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the following paragraph.

[Signature]

[Date]

[Source: Interpretation No. 8 of SAS No. 58, with conforming changes due to SAS No. 93 (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, 20X1, 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, 20X2 to April 25, 20X2. In addition, we have audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X to the financial statements, the stockholders of X Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation, as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the following paragraph.

[Signature]

[Date]

[Source: Interpretation No. 8 of SAS No. 58, with conforming changes due to SAS No. 93 (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, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

In our opinion, the balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 67, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (AU section 508.67).]

Note: This report assumes that the independent auditor has been able to satisfy himself as to the consistency of application of generally accepted accounting principles.

.140 Comparative Financial Statements—Subsequent Restatement of Prior-Period Financial Statements to Conform With Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our report dated March 1, 20X2, we expressed an opinion that the 20X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 20X1 financial statements, as presented herein, is different from that expressed in our previous report.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 69, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (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, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were reviewed by us (other accountants) and our (their) report thereon, dated March 1, 20X2, stated we (they) were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

[Signature]

[Date]

[Source: SAS No. 26, paragraph 17 (AU section 504.17).]

Notes: When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

When the financial statements are those of a public entity, the separate paragraph should include a disclaimer of opinion or a description of a review. (A sample of a disclaimer of opinion is provided in AAM section 10,210.170.)

.160 Comparative Financial Statements—Current Year's Statements Audited and Prior Year's Statements Compiled

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were compiled by us (other accountants) and our (their) report thereon, dated March 1, 20X2, stated we (they) did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.

[Signature]

[Date]

[Source: SAS No. 26, paragraph 17 (AU section 504.17).]

Note: When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

.170 Comparative Financial Statements—Current Year's Statements Audited and Disclaimer on Prior Year's Unaudited Statements**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were not audited by us and, accordingly, we do not express an opinion on them.

[Signature]

[Date]

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, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended which, as described in Note X, have been prepared on the basis of accounting principles accepted in *[name of country]*. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America (and in *[name of country]*). U.S. standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of International Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in *[name of country]*.

[Signature]

[Date]

Note: The above illustrates a report as described in SAS No. 51, paragraph 10, as amended and with conforming changes due to SAS No. 93 (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, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X to the financial statements, the Company has recorded fixed assets in excess of historical cost using appraised value as the basis for adjustment in accordance with accounting principles generally accepted in *[name of country]*. If the fixed assets had been recorded at historical cost, fixed assets and retained earnings would be decreased by \$XXX,XXX and \$XXX,XXX respectively, as of December 31, 20XX, and net income and earnings per share would be increased by \$X,XXX and \$X.XX respectively for the year then ended.

In our opinion, except for the effects of recording the fixed assets in excess of historical costs, discussed in the preceding paragraph, the financial statements present fairly, in all material respects, the financial position of International Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

(Optional Paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of the International Company at December 31, 20XX, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in *[name of country]*.

[Signature]

[Date]

Note: The above illustrates a report as described in SAS No. 51, paragraphs 14 and 15, as amended and with conforming changes due to SAS No. 93 (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, 20X2 and 20X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, certain errors resulting in an understatement of previously reported expenses for the years ended December 31, 20X1 and 20X0 were discovered by the Company's management during the current year. Accordingly, the 20X1 financial statements have been restated and an adjustment has been made to retained earnings as of January 1, 20X1 to correct the errors.

[Signature]

[Date]

[Sources: SAS No. 58, paragraph 8, as amended by SAS No. 79 and SAS No. 93, and SAS No. 1, section 420, paragraph 11 (AU sections 508.08 and 420.11, respectively).]

Note: This report would be used when the issuance of financial statements accompanied by the auditor's report for a subsequent period is imminent so that disclosure is not delayed (SAS No. 1, section 561, paragraph .06b [AU section 561.06b]).

.210 Subsequent Event Prior to Issuance of Auditor's Report**Independent Auditor's Report**

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material 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, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, on March 1, 20X3, the Company entered into an agreement to sell Subsidiary A. This Subsidiary represents X% 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 and SAS No. 93 (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, 20X2 and 20X1, and the related statements of income, retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material 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, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 10 to the financial statements, the Company's 20X2 [*specify account corrected*] previously reported as \$XX,XXX should have been \$X,XXX. This discovery was made subsequent to the issuance of the financial statements. The financial statements have been restated to reflect this correction.

[*Signature*]

[*March 31, 20X3, except for Note 10, as to which the date is April 30, 20X3*]

[Sources: SAS No. 1, section 561, paragraph .06a and SAS No. 58, paragraph 8, as amended by SAS No. 79 and SAS No. 93 (AU sections 561.06a and 508.08, respectively).]

[*The next page is 10,271.*]

AAM Section 10,220

Adverse Opinions

.01 Departures from GAAP

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X to the financial statements, the Company carries its property plant, and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Accounting principles generally accepted in the United States of America require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from accounting principles generally accepted in the United States of America identified above, as of December 31, 20X2 and 20X1, inventories have been increased \$_____ and \$_____ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant, and equipment, less accumulated depreciation, is carried at \$_____ and \$_____ in excess of an amount based on the cost to the Company; and deferred income taxes of \$_____ and \$_____ have not been recorded, resulting in an increase of \$_____ and \$_____ in retained earnings and appraisal surplus of \$_____ and \$_____, respectively. For the years ended December 31, 20X2 and 20X1, cost of goods sold has been increased \$_____ and \$_____, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of \$_____ and \$_____ have not been provided, resulting in an increase in net income of \$_____ and \$_____, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows for the years then ended.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 60, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (AU section 508.60).]

[The next page is 10,321.]

AAM Section 10,230

Disclaimers of Opinion

.01 Beginning Inventory Not Observed (First Examination)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.*

Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Because we were not engaged as auditors until after December 31, 20X1, we were not present to observe the physical inventory taken at that date and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities. Accordingly, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying statements of income, retained earnings and cash flows for the year ended December 31, 20X2.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 26, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (AU section 508.26).]

* Although the introductory paragraph of the standard disclaimer of opinion begins with "We were engaged to audit ..." and the scope paragraph of the report is omitted, SAS No. 58, paragraph 67, as amended by SAS No. 79 (AU section 508.67), shows that the introductory paragraph does not need to be modified nor does the scope paragraph need to be omitted when the disclaimed financial statements are with audited financial statements.

.02 Inability to Obtain Sufficient Competent Evidential Matter Due to a Scope Limitation**Independent Auditor's Report**

Addressee:

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at \$_____ as of December 31, 20X2, and at \$_____ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[Signature]

[Date]

[Source: 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, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by \$_____ and \$_____, long-term debt by \$_____ and \$_____, and retained earnings by \$_____ and \$_____ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by \$_____ and \$_____ and earnings per share would be increased (decreased) by \$_____ and \$_____, respectively, for the years then ended.

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at \$_____ as of December 31, 20X2, and at \$_____ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[Signature]

[Date]

[Source: SAS No. 58, paragraphs 39 and 63, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (AU section 508.39 and .63).]

Note: This report would be used if the GAAP departure is not so material to require an adverse opinion. See AAM section 10,220.01 for an example of an adverse opinion.

[The next page is 10,371.]

AAM Section 10,240

Qualified Opinions

.010 Scope Limitation—Investment in Foreign Affiliate (Assuming Effects Are Such That Qualification Rather Than Disclaimer is Appropriate)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at \$_____ and \$_____ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of \$_____ and \$_____, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 26, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (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, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by \$_____ and \$_____, long-term debt by \$_____ and \$_____, and retained earnings by \$_____ and \$_____ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by \$_____ and \$_____ and earnings per share would be increased (decreased) by \$_____ and \$_____, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 39, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (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, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheets.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 40, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (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, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 42, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (AU section 508.42).]

Note: This report assumes the effects are such that the auditor has concluded an adverse opinion is not appropriate.

.050 Inadequate Disclosure—Omission of Statement of Cash Flows**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income and retained earnings for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company declined to present a statement of cash flows for the years ended December 31, 20X2 and 20X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 44, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (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, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As disclosed in Note X to the financial statements, the Company adopted, in 20X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with accounting principles generally accepted in the United States of America, in our opinion the Company has not provided reasonable justification for making this change as required by those principles.

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 52, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (AU section 508.52).]

Note: If the change was from an accounting principle that is not generally accepted to one that is generally accepted it would be a correction of an error and would require recognition in the auditor's report as to consistency. However, because the middle paragraph contains all of the information required in an explanatory paragraph (following the opinion paragraph) as required by SAS No. 58, paragraphs 16–18, as amended by SAS No. 79 (AU section 508.16–.18), an explanatory paragraph is not required in this instance.

.070 Change to an Accounting Principle Not in Conformity With Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The company previously recorded its land at cost but adjusted the amounts to appraised values during the year, with a corresponding increase in stockholders' equity in the amount of \$_____. In our opinion, the new basis on which land is recorded is not in conformity with accounting principles generally accepted in the United States of America.

In our opinion, except for the change to recording appraised values as described above, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraph 55, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (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, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at \$_____ and \$_____ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of \$_____ and \$_____, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

The Company has excluded, from property and debt in the accompanying 20X2 balance sheet, certain lease obligations that were entered into in 20X2, which in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by \$_____, long-term debt by \$_____, and retained earnings by \$_____, as of December 31, 20X2. Additionally, net income would be increased (decreased) by \$_____ and earnings per share would be increased (decreased) by \$_____ for the year then ended.

In our opinion, except for the effects on the 20X2 and 20X1 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, and except for the effects of the 20X2 financial statements of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 58, paragraphs 26 and 39, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (AU section 508.26 and .39).]

[The next page is 10,421.]

AAM Section 10,245

Information Accompanying Audited Financial Statements

.010 Omission of Supplementary Information Required by the FASB

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company has not presented [*describe the supplementary information required by GAAP*¹] that accounting principles generally accepted in the United States has determined is necessary to supplement, although not required to be part of, the basic financial statements.

[Signature]

[Date]

[Source: SAS No. 52, paragraph 8, as amended by SAS No. 98 (AU section 558.08).]

¹ The auditor may identify the body requiring the information, such as the Financial Accounting Standards Board in this example.

.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, 20XX. 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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, 20XX, and the results of its operations and cash flows of its proprietary fund types for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The City of Example, Any State has not presented [*describe the supplementary information required by GAAP*²] that accounting principles generally accepted in the United States has determined is necessary to supplement, although not required to be part of, the basic financial statements.

[Signature]

[Date]

[Source: SAS No. 52, paragraph 8, as amended by SAS No. 98 (AU section 558.08).]

² The auditor may identify the body requiring the information, such as the Governmental Accounting Standards Board in this example.

.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, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [*specifically identify the supplementary information*] on page XX is not required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As result of such limited procedures, we believe that the [*specifically identify the supplementary information*] is not in conformity with accounting principles generally accepted in the United States because [*describe the material departure(s) from the GAAP³ guidelines*].

[Signature]

[Date]

[Source: SAS No. 52, paragraph 8, as amended by SAS No. 98 (AU section 558.08).]

Note: Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by GAAP. However, management may choose not to place the required supplementary information outside the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 11, as amended by SAS No. 98 (AU section 558.11).] (See AAM section 10,245.060.)

³ The auditor may identify the body requiring the information, such as the Financial Accounting Standards Board in this example

.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, 20XX. 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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, 20XX and the results of its operations and cash flows of its proprietary fund types for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The [*specifically identify the supplementary information*] on 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 accounting principles generally accepted in the United States because [*describe the material departure(s) from the GAAP⁴ guidelines*].

[Signature]

[Date]

[Source: SAS No. 52, paragraph 8, as amended by SAS No. 98 (AU section 558.08).]

Note: Ordinarily, the required supplementary information should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by GAAP. However, management may choose not to place the required supplementary information outside the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 11, as amended by SAS No. 98 (AU section 558.11).] (See AAM section 10,245.060.)

⁴ The auditor may identify the body requiring the information, such as the Governmental Accounting Standards Board in this example.

.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, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

[Signature]

[Date]

[Source: SAS No. 52, paragraph 8, as amended by SAS No. 98 (AU section 558.08).]

Notes: Even though the auditor is unable to complete the prescribed procedures, if, on a basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report. [Source: SAS No. 52, paragraph 8, as amended by SAS No. 98 (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 GAAP. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 11, as amended by SAS No. 98 (AU section 558.11).] (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, 20XX. 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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, 20XX, and the results of its operations and cash flows of its proprietary fund types for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The [*specifically identify the supplementary information*] on 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 8, as amended by SAS No. 98 (AU section 558.08).]

Notes: Even though the auditor is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report. [Source: SAS No. 52, paragraph 8, as amended by SAS No. 98 (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 GAAP. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 11, as amended by SAS No. 98 (AU section 558.11).] (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, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The *[specifically identify the supplementary information]* on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by accounting principles generally accepted in the United States. *[The auditor should consider including in the report the reason(s) he or she was unable to resolve his or her substantial doubts.]*

[Signature]

[Date]

[Source: SAS No. 52, paragraph 8, as amended by SAS No. 98 (AU section 558.08).]

Notes: Even though the auditor is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report. [Source: SAS No. 52, paragraph 8, as amended by SAS No. 98 (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 GAAP. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 11, as amended by SAS No. 98 (AU section 558.11).] (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, 20XX. 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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, 20XX, and the results of its operations and cash flows of its proprietary fund types for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The *[specifically identify the supplementary information]* on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by accounting principles generally accepted in the United States. *[The auditor should consider including in the report the reason(s) he or she was unable to resolve his or her substantial doubts.]*

[Signature]

[Date]

[Source: SAS No. 52, paragraph 8, as amended by SAS No. 98 (AU section 558.08).]

Notes: Even though the auditor is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report. [Source: SAS No. 52, paragraph 8, as amended by SAS No. 98 (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 GAAP. However, management may choose not to place the required supplementary information outside of the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. [Source: SAS No. 52, paragraph 11, as amended by SAS No. 98 (AU section 558.11).] (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, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature]

[Date]

[Source: SAS No. 29, paragraph 12, as amended by SAS No. 52 and SAS No. 98 (AU section 551.12).]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

.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, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify the accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

[Signature]

[Date]

[Source: SAS No. 29, paragraph 13, as amended by SAS No. 52 (AU section 551.13).]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When the auditor disclaims an opinion on all or part of the accompanying information in a document that he or she submits to his or her client or to others, such information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances.

.070 Disclaimer on Part of the Accompanying Information (Not Audited)**Independent Auditor's Report**

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information on pages XX-YY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "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).]

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, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by \$_____ and \$_____, long-term debt by \$_____ and \$_____, and retained earnings by \$_____ and \$_____ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by \$_____ and \$_____ and earnings per share would be increased (decreased) by \$_____ and \$_____, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedules of property and related depreciation (page X), and long-term debt with related interest (page Y), as of December 31, 20X2, are presented for purposes of additional analysis and are not a required part of the basic financial statements. The information in such schedules has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, except for the effects on the schedule of property of not capitalizing certain lease obligations as explained in the third paragraph of this report, such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature]

[Date]

[Sources: SAS No. 29, paragraph 14, as amended by SAS No. 52, and SAS No. 58, paragraph 39, as amended by SAS No. 79 and with conforming changes due to SAS No. 93 (AU sections 551.14 and 508.39, respectively).]

Note: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

.090 Supplementary Information Required by the FASB Included in Auditor-Submitted Document
Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [identify the supplementary information] on page XX is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

[Signature]

[Date]

[Source: SAS No. 29, paragraph 15, as amended by SAS No. 52 and SAS No. 98 (AU section 551.15).]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When supplementary information required by GAAP is presented outside the basic financial statements in an auditor-submitted document, the auditor should (a) express an opinion on the information if the auditor has been engaged to examine the information, (b) report on the information using the guidance in paragraphs 12 and 14 of SAS No. 29 (AU section 551.12–.14), provided such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, or (c) disclaim an opinion on the information.⁵

In certain circumstances, the auditor's report should be expanded in accordance with SAS No. 52, paragraphs 8 and 9, as amended by SAS No. 98 (AU section 558.08 and .09). The illustrative reports at AAM section 10,245.010–.045 are assembled from illustrative reporting language in SAS No. 52, paragraph 8 (AU section 558.08).

⁵ The auditor may identify the body requiring the information, such as the Financial Accounting Standards Board in this example.

.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, 20XX. 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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, 20XX, and the results of its operations and cash flows of its proprietary fund types for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

[*Signature*]

[*Date*]

[Source: SAS No. 29, paragraph 15, as amended by SAS No. 52 and SAS No. 98 (AU section 551.15).]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted documents.

When supplementary information required by GAAP is presented outside the basic financial statements in an auditor-submitted document, the auditor should (a) express an opinion on the information if the auditor has been engaged to examine the information, (b) report on the information using the guidance in paragraphs 12 and 14 of SAS No. 29 (AU section 551.12 and .14), provided such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, or (c) disclaim an opinion on the information.⁶

In certain circumstances, the auditor's report should be expanded in accordance with SAS No. 52, paragraphs 8 and 9 (AU section 558.08 and .09). The illustrative reports at AAM section 10,245.010-.045 are assembled from illustrative reporting language in SAS No. 52, paragraph 8 (AU section 558.08).

⁶ The auditor may identify the body requiring the information, such as the Governmental Accounting Standards Board in this example.

.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, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company and subsidiaries as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

[Signature]

[Date]

[Source: SAS No. 29, paragraph 18, as amended by SAS No. 52 (AU section 551.18).]

Notes: The report on the consolidating information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

When the auditor is engaged to express an opinion only on the consolidated financial statements and consolidating information is also included, the auditor should be satisfied that the consolidating information is suitably identified. For example, when the consolidated financial statements include columns of information about the components of the consolidated group, the balance sheets might be titled, "Consolidated Balance Sheet—December 31, 20X1, with Consolidating Information," and the columns including the consolidating information might be marked, "Consolidating Information." When the consolidating information is presented in separate schedules, the schedules presenting balance sheet information of the components might be titled, for example, "Consolidating Schedule, Balance Sheet Information, December 31, 20X1."

.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, 20X5 and 20X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 20X5. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company and subsidiaries as of December 31, 20X5 and 20X4, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 20X5 in conformity with accounting principles generally accepted in the United States of America.

We have also previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheets as of December 31, 20X3, 20X2, and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years ended December 31, 20X2 and 20X1 (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements.

In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 20X5, appearing on page XX, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[Signature]

[Date]

[Source: SAS No. 42, paragraph 10, with conforming changes due to SAS No. 93 (AU section 552.10).]

[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 the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*]. W Company's management is responsible for maintaining effective internal control over financial reporting. 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 internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].¹

[Source: SSAE No. 10, chapter 5, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph 5.48 (AT section 501.48)]

¹ 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 When Expressing an Opinion on a Written 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, 20XX based on [*identify criteria*].¹ W Company's 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 internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that W Company maintained effective internal control over financial reporting as of December 31, 20XX is fairly stated, in all material respects, based on [*identify criteria*].²

[Source: SSAE No. 10, chapter 5, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph 5.50 (AT section 501.50).]

Note: Nothing precludes the practitioner from examining an assertion but opining directly on the effectiveness of internal control. SSAE No. 10, chapter 5, paragraph 5.51 (AT section 501.51).

¹ The practitioner should identify the responsible party's report examined by referring to the title used by the responsible party in its report. Further, he or she should use the same description of the entity's internal control as the responsible party uses in its reports, including the kinds of controls (that is, control over the preparation of annual financial statements, interim financial statements, or both) on which the responsible party is reporting. If the presentation of the assertion does not accompany the practitioner's report, the phrase "included in the accompanying [*title of responsible party's report*]" would be omitted.

² For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.030 Modified Report With Explanatory Language, That a Practitioner Should Use When There Is a Material Weakness in an Entity's Internal Control and, Based on Its Significance and Its Effect on the Achievement of the Objectives of the Control Criteria, the Practitioner Concludes That a Qualified Opinion Is Appropriate

Independent Accountant's Report

We have examined the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*. W Company's management is responsible for maintaining effective internal control over financial reporting. 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 internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[Include sentence(s) describing the material weakness and its effect on the achievement of the objectives of the control criteria.] We believe such 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.¹

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 maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.

[Source: SSAE No. 10, chapter 5, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph 5.55 (AT section 501.55).]

Note: If the practitioner's report on his or her examination of 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 20XX financial statements, and this report does not affect our report dated *[date of report]* on these financial statements.²

[Source: SSAE No. 10, chapter 5, paragraphs 5.55 and 5.58 (AT section 501.55 and .58).]

¹ This description of a material weakness differs from the definition of material weakness discussed in SSAE No. 10, chapter 5, paragraph 5.37 (AT section 501.37). Although a practitioner should consider the definition contained in SSAE No. 10, chapter 5, paragraph 5.37 (AT section 501.37) when determining whether a material weakness exists, the description above should be used to describe a material weakness in the practitioner's report.

² The practitioner may also include the preceding sentence in situations where the two reports are not included within the same document.

.040 Adverse Opinion on When a Material Weakness in Internal Control Exists and, in the Practitioner's Judgment, the Material Weakness(es) Is (Are) So Pervasive That the Entity's Internal Control Over Financial Reporting Does Not Achieve the Control Objectives

Independent Accountant's Report

We have examined the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*. W Company's management is responsible for maintaining effective internal control over financial reporting. 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 internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[Include sentence(s) describing the material weakness and its effect on the achievement of the objectives of the control criteria.] We believe such 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.¹

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.

[Source: SSAE No. 10, chapter 5, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph 5.56 (AT section 501.56).]

Note: If the practitioner's report on his or her examination of 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 20XX financial statements, and this report does not affect our report dated *[date of report]* on these financial statements.²

[Source: SSAE No. 10, chapter 5, paragraphs 5.56 and 5.58 (AT section 501.56 and .58).]

¹ This description of a material weakness differs from the definition of a material weakness discussed in SSAE No. 10, chapter 5, paragraph 5.37 (AT section 501.37). Although a practitioner should consider the definition contained in SSAE No. 10, chapter 5, paragraph 5.37 (AT section 501.37) when determining whether a material weakness exists, the description above should be used to describe a material weakness in the practitioner's report

² The practitioner may also include the preceding sentence in situations where the two reports are not included within the same document.

.050 Qualified Opinion on the Effectiveness of an Entity's Internal Control, or Written Assertion Thereon, Due to a Scope Limitation

Independent Accountant's Report

We have examined the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*. W Company's management is responsible for maintaining effective internal control over financial reporting. 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.

Prior to December 20, 20XX, 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. We believe this condition was a material weakness in the design or operation of the internal control of W Company in effect at *[date]*. A material weakness is a condition that precludes the entity's internal control from providing reasonable assurance that material misstatements in the financial statements will be prevented or detected on a timely basis. Although the Company implemented a new cash receipts system on December 20, 20XX, 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 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, 20XX based on *[identify criteria]*.

[Source: SSAE No. 10, chapter 5, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph 5.60 (AT section 501.60).]

.060 Disclaimer of Opinion When Restrictions That Significantly Limit the Scope of the Examination Are Imposed by the Client or the Responsible Party

Independent Accountant's Report

We were engaged to examine the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*. W Company's management is responsible for maintaining effective internal control over financial reporting.

[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. 10, chapter 5, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph 5.62 (AT section 501.62).]

.070 Unqualified Opinion When the Practitioner Decides to Make Reference to the Report of Another Practitioner as a Basis, in Part, for the Practitioner's Opinion

[In these circumstances, the practitioner should disclose this fact when describing the scope of the examination and should refer to the report of the other practitioner when expressing the opinion.¹]

Independent Accountant's Report

We have examined the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*. W Company's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination. We did not examine the effectiveness of 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, 20XX. 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 internal control over financial reporting, testing, and evaluating the design and operating effectiveness of 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 inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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, 20XX, based on *[identify criteria]*.

[Source: SSAE No. 10, chapter 5, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph 5.64 (AT section 501.64).]

¹ Whether the other practitioner's opinion is expressed on the responsible party's assertion or on the effectiveness of internal control does not affect the determination of whether the principal practitioner's opinion is expressed on the assertion or on the subject matter itself.

.080 Unqualified Opinion on the Effectiveness of Only a Segment of an Entity's Internal Control

[For example, internal control over financial reporting of an entity's operating division or its accounts receivable]

Independent Accountant's Report

We have examined the effectiveness of W Company's internal control over financial reporting for its retail division as of December 31, 20XX, based on *[identify criteria]*. W Company's 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 internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

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 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, 20XX based on *[identify criteria]*.

[Source: SSAE No. 10, chapter 5, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph 5.69 (AT section 501.69).]

.090 Unqualified Opinion About the Suitability of Design of the Entity's Internal Control**Independent Accountant's Report**

We have examined the suitability of W Company's design of internal control over financial reporting to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 20XX, based on *[identify criteria]*. W Company's 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 internal control over financial reporting, evaluating the design of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

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, 20XX, based on *[identify criteria]*.

[Source: SSAE No. 10, chapter 5, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph 5.71 and footnote 24 (AT section 501.71).]

Notes: This report assumes that the control criteria of the regulatory agency are both suitable and available to users as discussed in SSAE No. 10, chapter 1, *Attest Engagements*, paragraphs 1.23 through 1.33 (AT section 101.23–.33). Therefore, there is no restriction 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, 20XX, and, accordingly, we express no opinion on operating effectiveness.

.100 Unqualified Opinion Based on an Examination on the Adequacy of an Entity's Internal Control Over Financial Reporting Based on Criteria Established by a Regulatory Agency That Are Not Suitable for General Use

Independent Accountant's Report

We have examined the adequacy of W Company's internal control over financial reporting as of December 31, 20XX, based on the criteria established by _____ agency, as set forth in its audit guide dated _____. W Company's management is responsible for maintaining adequate 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 internal control over financial reporting, testing, and evaluating the design and operating effectiveness of internal control and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that 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, based on the criteria established by _____ agency.

This report is intended solely for the information and use of the board of directors and management of W Company and [agency] and is not intended to be and should not be used by anyone other than these specified parties.

[Source: SSAE No. 10, chapter 5, *Reporting on an Entity's Internal Control Over Financial Reporting*, paragraph 5.74 (AT section 501.74).]

.110 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, 20XX, 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).]

.120 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, 20XX, 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).]

.130 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) 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,¹ 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).]

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.

¹ 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.

.140 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,¹ 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.]²

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.

¹ 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.

² 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).]

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.

.150 Reports on Internal Control Required by SEC Rule 17a-5

Board of Directors

Standard Stockbrokerage Co., Inc.

In planning and performing our audit of the consolidated financial statements of Standard Stockbrokerage Co., Inc. (the Company) for the year ended December 31, 20X1, 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 recodation 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 conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control 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

^{*} 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.¹

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, 20X1, to meet the SEC's objectives.²

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, 20X2

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix D.]

Note: AAM section 10,650 illustrates the auditor's reports on the financial statements of brokers and dealers in securities.

¹ If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fifth paragraph of the report should be modified as follows:

However, we noted the following matters involving the [control environment, accounting system, control 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, 20X1, and this report does not affect our report thereon dated February 15, 20X2.
[A description of the material weaknesses that have come to the auditor's attention and corrective action would follow.]

² Whenever inadequacies are described, the report should include the last sentence of the fifth paragraph as modified in the note above. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period unless management already has reported them to the SEC.

.160 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, 20X0, and for the year then ended, which we reported on under date of February 15, 20X1. We have not audited any financial statements of the Company as of any date or for any period subsequent to December 31, 20X0. Although we are presently performing certain procedures as part of our audit of the consolidated financial statements of the Company as of December 31, 20X1, and for the year then ending, these procedures do not constitute all the procedures necessary in an audit conducted in accordance with auditing standards generally accepted in the United States of America or all 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 conformity with accounting principles generally accepted in the United States of America.

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, 20X1

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix F.]

Note: AAM section 10,650 illustrates the auditor's reports on the financial statements of brokers and dealers in securities.

.170 Independent Auditor's Report on Internal Control 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, 20X1, 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 conformity with generally accepted accounting principles. Regulation 1.16 lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in 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 internal control, including procedures for safeguarding customer and firm assets, that we consider to be material weaknesses as defined above.¹

¹ If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fifth paragraph of the report should be modified as follows:

However, we noted the following matters involving the [(control environment, accounting system, control 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, 20X1, and this report does not affect our report thereon dated February 15, 20X2.
[A description of the material weaknesses that have come to the auditor's attention and corrective action would follow]

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, 20X1, to meet the CFTC's objectives.²

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, 20X2

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix G.]

[The next page is 10,521.]

² Whenever inadequacies are described, the report should include the last sentence of the fifth paragraph as modified in the note above. The report should also describe material inadequacies the auditor becomes aware of that existed during the period but were corrected prior to the end of the period unless management already has reported them to the CFTC.

AAM Section 10,260

Special Reports

.010 Cash Basis Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of revenue collected and expenses paid for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20X2 and 20X1, and its revenue collected and expenses paid during the years then ended, on the basis of accounting described in Note X.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 8, as amended by SAS No. 77 and with conforming changes due to SAS No. 87 and No. 93 (AU section 623.08).]

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, 20X2 and 20X1, and the related statements of revenue and expenses—income tax basis and of changes in partners' capital accounts—income tax basis for the years then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of ABC Partnership as of December 31, 20X2 and 20X1, and its revenue and expenses and changes in partners' capital accounts for the years then ended, on the basis of accounting described in Note X.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 8, as amended by SAS No. 77 and with conforming changes due to SAS No. 87 and No. 93 (AU section 623.08).]

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, 20X2 and 20X1, and the related statements of income and cash flows—statutory basis and changes in surplus—statutory basis for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our 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, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Insurance Company and [name of regulatory agency] and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 8, as amended by SAS No. 77 and with conforming changes due to SAS No. 87 and No. 93 (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, 20XX, between ABC Company, as lessor, and XYZ Stores Corporation, as lessee) of XYZ Stores Corporation at its Main Street store, [City], [State], for the year ended December 31, 20X2. This schedule is the responsibility of XYZ Stores Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of gross sales is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of gross sales. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of gross sales referred to above 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, 20X2, as defined in the lease agreement referred to in the first paragraph.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Stores Corporation and ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 18, with conforming changes due to SAS No. 87 and No. 93 (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, 20X2, under the terms of a license agreement dated May 14, 20XX, between ABC Company and XYZ Corporation. This schedule is the responsibility of XYZ Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of royalties is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that, under XYZ Corporation's interpretation of the agreement referred to in the first paragraph, royalties were based on the number of engines produced after giving effect to a reduction for production retirements that were scrapped, but without a reduction for field returns that were scrapped, even though the field returns were replaced with new engines without charge to customers.

In our opinion, the schedule of royalties referred to above presents fairly, in all material respects, the number of engines produced by the Q Division of XYZ Corporation during the year ended December 31, 20X2, and the amount of royalties applicable thereto, under the license agreement referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Corporation and ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 18, with conforming changes due to SAS No. 87 and No. 93 (AU section 623.18).]

.060 Profit Participation¹

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor's Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company for the year ended December 31, 20X1, and have issued our report thereon dated March 10, 20X2. We have also audited XYZ Company's schedule of John Smith's profit participation for the year ended December 31, 20X1. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit of the schedule in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule of profit participation is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

We have been informed that the documents that govern the determination of John Smith's profit participation are (a) the employment agreement between John Smith and XYZ Company dated February 1, 20X0, (b) the production and distribution agreement between XYZ Company and Television Network Incorporated dated March 1, 20X0, and (c) the studio facilities agreement between XYZ Company and QRX Studios dated April 1, 20X0, as amended November 1, 20X0.

In our opinion, the schedule of profit participation referred to above presents fairly, in all material respects, John Smith's participation in the profits of XYZ Company for the year ended December 31, 20X1, in accordance with the provisions of the agreements referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Company and John Smith and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 18, with conforming changes due to SAS No. 87 and No. 93 (AU section 623.18).]

¹ If a specified element, account, or item is, or is based upon, an entity's net income or stockholder's equity or the equivalent thereof (e.g., profit participation), the auditor should have audited the complete financial statements to express an opinion on the specified element, account, or item.

.070 Report on Federal and State Income Taxes in Financial Statements¹**(Report on one or more specified elements, accounts, or items of a financial statement)****Independent Auditor's Report**

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company, Inc., for the year ended June 30, 20XX, and have issued our report thereon dated August 15, 20XX. We have also audited the current and deferred provision for the Company's federal and state income taxes for the year ended June 30, 20XX, included in those financial statements, and the related asset and liability tax accounts as of June 30, 20XX. This income tax information is the responsibility of the Company's management. Our responsibility is to express an opinion on it based on our audit.

We conducted our audit of the income tax information in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the federal and state income tax accounts are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures related to the federal and state income tax accounts. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the federal and state income tax accounts. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Company has paid or, in all material respects, made adequate provision in the financial statements referred to above for the payment of all federal and state income taxes and for related deferred income taxes that could be reasonably estimated at the time of our audit of the financial statements of XYZ Company, Inc., for the year ended June 30, 20XX.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 18, with conforming changes due to SAS No. 87 and No. 93 (AU section 623.18).]

¹ If a specified element, account, or item is, or is based upon, an entity's net income or stockholder's equity or the equivalent thereof (e.g., Federal and State Income Taxes), the auditor should have audited the complete financial statements to express an opinion on the specified element, account, or item.

.080 Proposed Acquisition

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

To the Board of Directors and Management of X Company:

We have performed the procedures enumerated below, which were agreed to by the Board of Directors and Management of X Company, solely to assist you in connection with the proposed acquisition of Y Company as of December 31, 20XX. Y Company is responsible for its cash and accounts receivable records. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures and the associated findings are as follows:

Cash

1. We obtained confirmation of the cash on deposit from the following banks, and we agreed the confirmed balance to the amount shown on the bank reconciliations maintained by Y Company. We mathematically checked the bank reconciliations and compared the resultant cash balances per book to the respective general ledger account balances.

<u>Bank</u>	<u>General Ledger Account Balances as of December 31, 20XX</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, 20XX, 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:

<i>Accounts Receivable December 31, 20XX</i>			
<u><i>Aging Categories</i></u>	<u><i>Customer Account Balances</i></u>	<u><i>Confirmations Requested</i></u>	<u><i>Confirmation Replies Received</i></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 conduct an audit, the objective of which would be the expression of an opinion on cash and accounts receivable. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the board of directors and management of X Company and is not intended to be and should not be used by anyone other than these specified parties.

[Source: SSAE No. 10, chapter 2, Appendix, "Additional Illustrative Reports" (AT section 201.48).]

.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 solely to assist you in determining the validity of claims of XYZ Company as of May 31, 20XX, as set forth in accompanying Schedule A. XYZ Company is responsible for maintaining records of claims submitted by creditors of XYZ Company. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the party specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures and associated findings are as follows:

1. Compare the total of the trial balance of accounts payable at May 31, 20XX, prepared by XYZ Company, to the balance in the related general ledger account.

The total of the accounts payable trial balance agreed with the balance in the related general ledger account.

2. Compare the amounts for claims received from creditors (as shown in claim documents provided by XYZ Company) to the respective amounts shown in the trial balance of accounts payable. Using the data included in the claims documents and in XYZ Company's accounts payable detail records, reconcile any differences found to the accounts payable trial balance.

All differences noted are presented in column 3 of Schedule A. Except for those amounts shown in column 4 of Schedule A, all such differences were reconciled.

3. Obtain the documentation submitted by creditors in support of the amounts claimed and compare it to the following documentation in XYZ Company's files: invoices, receiving reports, and other evidence of receipt of goods or services.

No exceptions were found as a result of these comparisons.

We were not engaged to, and did not, conduct an audit, the objective of which would be the expression of an opinion on the claims of creditors set forth in the accompanying Schedule A. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the Trustee of XYZ Company and is not intended to be and should not be used by anyone other than this specified party.

[Source: SSAE No. 10, chapter 2, Appendix, "Additional Illustrative Reports" (AT section 201.48).]

.100 Compliance With Contractual Provisions (Separate Report)

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of XYZ Company as of December 31, 20X2, and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated February 16, 20X3.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to XX, inclusive, of the Indenture dated July 21, 20X0, with ABC Bank insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the boards of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

[Source: SAS No. 62, paragraph 21, with conforming changes due to SAS No. 87 and No. 93 (AU section 623.21).]

Note: When this report is included in the auditor's standard report accompanying financial statements, the last two paragraphs are examples of the paragraphs that should follow the opinion paragraph of the auditor's report on the financial statements.

.110 Report on Financial Statements Prepared Pursuant to Loan Agreements That Results in a Presentation Not in Conformity With Generally Accepted Accounting Principles or an Other Comprehensive Basis of Accounting

Independent Auditor's Report

Addressee:

We have audited the accompanying special-purpose statement of assets and liabilities of ABC Company as of December 31, 20X1, 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 auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The 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, 20X1, 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, with conforming changes due to SAS No. 87 and No. 93 (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, 20XX. These Historical Summaries are the responsibility of the Apartments' management. Our responsibility is to express an opinion on the Historical Summaries based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Historical Summaries are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Historical Summaries. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Historical Summaries. We believe that our audits provide a reasonable basis for our opinion.

The accompanying Historical Summaries were prepared for the purpose of complying with the rules and regulations of the Securities and Exchange Commission (for inclusion in the registration statement on Form S-11 of DEF 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, 20XX, in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 26, with conforming changes due to SAS No. 87 and No. 93 (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, 20XX. This statement of net assets sold is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the statement of net assets based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statement of net assets sold is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statement of net assets sold. We believe that our audit provides a reasonable basis for our opinion.

The accompanying statement was prepared to present the net assets of ABC Company sold to XYZ Corporation pursuant to the purchase agreement described in Note X, and is not intended to be a complete presentation of ABC Company's assets and liabilities.

In our opinion, the accompanying statement of net assets sold presents fairly, in all material respects, the net assets of ABC Company as of June 8, 20XX, sold pursuant to the purchase agreement referred to in Note X, in conformity with accounting principles generally accepted in the United States of America.

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and XYZ Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

[Source: SAS No. 62, paragraph 26, with conforming changes due to SAS No. 87 and No. 93 (AU section 623.26).]

.130 Report on the Application of Accounting Principles*

Introduction

We have been engaged to report on the appropriate application of accounting principles generally accepted in the United States of America to the specific transaction described below. This report is being issued to ABC Company for assistance in evaluating accounting principles for the described specific transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

Description of Transaction

The facts, circumstances, and assumptions relevant to the specific transaction as provided to us by the management of ABC Company are as follows:

[Describe transaction]

Appropriate Accounting Principles

[Text discussing generally accepted accounting principles]

Concluding Comments

The ultimate responsibility for the decision on the appropriate application of accounting principles generally accepted in the United States of America 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 accounting principles generally accepted in the United States of America for the described specific transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change.

Restricted Use

This report is intended solely for the information and use of the board of directors and management of ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[Source: SAS No. 50, as amended, paragraph 11, as amended by SAS No. 97 (AU section 625.11).]

Notes: This illustrative report is intended for a reporting accountant either in connection with a proposal to obtain a new client or otherwise, should apply when preparing a written report on (1) The application of accounting principles to specified transactions, either completed or proposed, involving facts and circumstances of a specific entity ("specific transactions"), or (2) The type of opinion that may be rendered on a specific entity's financial statements.

[Source: SAS No. 50, as amended, paragraph 3, as amended by SAS No. 97 (AU section 625.03).]

Because of the nature of a transaction not involving facts or circumstances of a specific entity ("hypothetical transaction"), a reporting accountant cannot know, for example, whether the continuing accountant has reached a different conclusion on the application of accounting principles for the same or similar transaction, or how the specific entity has accounted for similar transactions in the past. Therefore an accountant should not undertake an engagement to provide a written report on the application of accounting principles to a hypothetical transaction.

[Source: SAS No. 97, paragraph 4 (AU section 625.04)]

* In June 2002, the Auditing Standards Board issued SAS No. 97, *Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles* (AU section 625). This Statement revises SAS No. 50 (AU section 625) to prohibit an accountant from providing a written report on the application of accounting principles not involving facts and circumstances of a specific entity.

**.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, 20X2 and 20X1, and the related statutory statements of income and changes in surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 statutory accounting practices and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of ABC Insurance Company as of December 31, 20X2 and 20X1, 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, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*, paragraph 8.27]

[The next page is 10,571.]

AAM Section 10,270

Unaudited Financial Statements of a Public Entity

(When an accountant is associated with the financial statements but has not audited or reviewed such statements)

.01 Disclaimer

Addressee:

The accompanying balance sheet of X Company as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us, and, accordingly, we do not express an opinion on them.

[Signature]

[Date]

[Source: SAS No. 26, paragraph 5 (AU section 504.05).]

Notes: The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a privately held (nonpublic) company, this example is not appropriate. See AAM sections 2510 and 2520.

.02 Current Period Financial Statements Unaudited—Prior Period Financial Statements Audited

Addressee:

The accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

The financial statements for the year ended December 31, 20X1, were audited by us (other accountants) and we (they) expressed an unqualified opinion on them in our (their) report dated March 1, 20X2, but we (they) have not performed any auditing procedures since that date.

[Signature]

[Date]

[Source: SAS No. 26, paragraphs 5 and 16 (AU section 504.05 and .16).]

Notes: The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a privately held (nonpublic) company, this example is not appropriate. See AAM sections 2510 and 2520.

.03 Disclaimer—Cash Basis Statements

(When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles)

Addressee:

The accompanying statement of assets and liabilities resulting from cash transactions of XYZ Corporation as of December 31, 20X1, and the related statement of revenues collected and expenses paid during the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[Signature]

[Date]

[Source: SAS No. 26, paragraph 7 (AU section 504.07).]

Notes: A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.

The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a privately held (nonpublic) company, this example is not appropriate. See AAM sections 2510 and 2520.

.04 Disclaimer—Regulatory (Statutory) Basis Statements

(When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles)

Addressee:

The accompanying statement of admitted assets, liabilities, and surplus—statutory basis of XYZ Insurance Company as of December 31, 20XX, and the related statements of income—statutory basis, cash flows—statutory basis, and changes in surplus—statutory basis for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[Signature]

[Date]

[Source: SAS No. 26, paragraph 7 (AU section 504.07).]

Notes: A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.

The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a privately held (nonpublic) company, this example is not appropriate. See AAM sections 2510 and 2520.

[The next page is 10,621.]

AAM Section 10,280

Lack of Independence

.01 Disclaimer

Addressee:

We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 20X1 and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[Signature]

[Date]

[Source: SAS No. 26, paragraph 10 (AU section 504.10).]

Notes: When an accountant is not independent, any procedures he or she might perform would not be in accordance with generally accepted auditing standards and he or she would be precluded from expressing an opinion on the financial statements. Accordingly, he or she should disclaim an opinion with respect to the financial statements and state specifically that he or she is not independent. The accountant should not include in his or her disclaimer the reasons for the lack of independence or any description of the procedures he or she has performed; including such matters might confuse readers concerning the importance of the lack of independence.

If the financial statements are those of a nonpublic entity, the guidance in Statements on Standards for Accounting and Review Services (SSARS) should be followed. (See AAM section 2510.03.)

[The next page is 10,671.]

AAM Section 10,300

Review of Interim Financial Information

.01 Independent Accountant's Report

Independent Accountant's Report

Addressee:

We have reviewed the accompanying *[describe the interim financial information or statements reviewed]* of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. This (these) interim financial information (statements) is (are) the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures 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 interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: SAS No. 100, paragraph 38 (AU section 722.38).]

Note: SAS No. 100, *Interim Financial Information* (AU section 722), provides guidance on the nature, timing, and extent of the procedures to be performed by an independent accountant when conducting a review of interim financial information, as that term is defined in paragraph 2 of SAS No. 100 (AU section 722.02). SAS No. 100 (AU section 722) is effective for interim periods within fiscal years beginning after December 15, 2002, with earlier application permitted. The accountant should refer to the SAS to determine its applicability.

[The next page is 10,701.]

AAM Section 10,400

Accountants' Reports on Condensed Financial Statements and Selected Financial Data

.01 Unqualified Opinion on Condensed Financial Statements¹

Independent Auditor's Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements.

In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[Signature]

[Date]

[Source: SAS No. 42, paragraph 6, with conforming changes due to SAS No. 93 (AU section 552.06).]

¹ This report is appropriate when reporting in a client-prepared document on condensed financial statements (either for an annual or an interim period) that are derived from audited financial statements of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency (See SAS No. 42, paragraph 1a [AU section 552.01a]).

.02 Adverse Opinion on Condensed Financial Statements Due to Inadequate Disclosure²**Independent Auditor's Report**

Addressee:

We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related earnings and cash flows for the year then ended (not presented herein). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The condensed consolidated balance sheet as of December 31, 20X0, and the related condensed 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 accounting principles generally accepted in the United States of America.

In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company and subsidiaries as of December 31, 20X0, or results of their operations and their cash flows for the year then ended.

[Signature]

[Date]

[Source: SAS No. 42, paragraph 7, footnote 6, with conforming changes due to SAS No. 93 (AU section 552.07).]

² This report is appropriate if a statement naming the auditor and stating that condensed financial statements have been derived from audited financial statements is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency at least annually (See SAS No. 42, paragraph 7, footnote 6 [AU section 552.07]).

.03 Review Report on Condensed Financial Statements**Independent Auditor's Report**

Addressee:

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0. These financial statements are the responsibility of the company's management.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures 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 accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of ABC Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated in all material respects, in relation to the consolidated balance sheet from which it has been derived.

[Signature]

[Date]

[Source: SAS No. 100, paragraph 39 (AU section 722.39).]

Note: This is an illustrative review report on a condensed balance sheet as of March 31, 20X1, and the related condensed statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and a condensed balance sheet derived from audited financial statements as of December 31, 20X0, included in Form 10-Q.

[The next page is 10,751.]

AAM Section 10,500

Reports on Personal Financial Statements

.01 Auditor's Standard Report

Independent Auditor's Report

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

In my (our) opinion, the financial statements referred to above present fairly, in all material respects, the financial condition of James and Jane Person as of [date] and the changes in their net worth for the [period] then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.14.]

.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 auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting 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 accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.21.]

.03 Audit Report—Departure From GAAP—Inappropriate Valuation Methods—Adverse Opinion**Independent Auditor's Report**

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

As discussed in Note X to the financial statements, assets amounting to \$XX,XXX (XX percent of total assets) as of [date] have been valued at estimated current value as determined by James Person. I (We) have reviewed the procedures applied by James Person in valuing the assets and have inspected the underlying documentation. In my (our) opinion those procedures are not appropriate to determine the estimated current values of the assets in conformity with generally accepted accounting principles. The effects on the financial statements of not applying appropriate procedures to determine the estimated current values of the assets are not reasonably determinable.

In my (our) opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial condition of James and Jane Person as of [date] and the changes in their net worth for the [period] then ended.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.19.]

.04 Audit Report—Departure From GAAP—Inappropriate Valuation Methods—Qualified Opinion**Independent Auditor's Report**

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

As discussed in Note X to the financial statements, assets amounting to \$XX,XXX (XX percent of total assets) as of [date] have been valued at estimated current value as determined by James Person. I (We) have reviewed the procedures applied by James Person in valuing the assets and have inspected the underlying documentation. In my (our) opinion, 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 accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.18.]

.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 5.17.]

.06 Audit Report—Scope Limitation—Inadequate Records**Independent Auditor's Report**

Addressee:

I (We) have audited the accompanying statement of financial condition of James and Jane Person as of *[date]*, and the related statement of changes in net worth for the *[period]* then ended. These financial statements are the responsibility of James and Jane Person. My (our) responsibility is to express an opinion on these financial statements based on my (our) audit.

Except as explained in the following paragraph, I (we) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

James and Jane Person do not maintain accounting records sufficient to assure that all transactions are recorded. Accordingly, it was not practicable for me (us) to extend my (our) auditing procedures sufficiently to determine that all of their assets and liabilities and the changes in their net worth are recorded in the financial statements referred to above.

In my (our) opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had I (we) been able to determine that all assets and liabilities and changes in net worth were recorded in the financial statements, the financial statements referred to 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 accounting principles generally accepted in the United States of America.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.16.]

.07 Audit Report—Income Tax Basis**Independent Auditor's Report**

Addressee:

I (We) have audited the accompanying statement of assets and liabilities—income tax basis of James and Jane Person as of *[date]*, and the related statement of changes in net worth—income tax basis for the *[period]* then ended. These financial statements are the responsibility of James and Jane Person. My (Our) responsibility is to express an opinion on these financial statements based on my (our) audit.

I (We) conducted my (our) audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that I (we) plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by James and Jane Person, as well as evaluating the overall financial statement presentation. I (We) believe that my (our) audit provides a reasonable basis for my (our) opinion.

As described in Note X, these financial statements were prepared on the basis of accounting James and Jane Person use for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In my (our) opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities of James and Jane Person as of *[date]*, and the changes in their net assets for the *[period]* then ended on the basis of accounting described in Note X.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.20.]

.08 Accountant's Standard Compilation Report

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.04.]

.09 Compilation Report—Statement of Financial Condition Only

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [date], in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of the individuals whose financial statements are presented. I (We) have not audited or reviewed the accompanying statement of financial condition and, accordingly, do not express an opinion or any other form of assurance on it.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.21.]

.10 Compilation Report—Omission of Substantially All Disclosures

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

James and Jane Person have elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the financial condition of James and Jane Person and changes in their net worth. Accordingly, these financial statements are not designed for those who are not informed about such matters.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.05.]

Note: When personal financial statements omit substantially all disclosures and do not disclose that the assets are presented at their estimated current values and that the liabilities are presented at their estimated current amounts, the accountant should include the following sentence at the end of the first paragraph of his or her report:

The financial statements are intended to present the assets of James and Jane Person at estimated current values and their liabilities at estimated current amounts.

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.06.]

.11 Compilation Report—GAAP Departure—Material Assets at Cost

Addressee:

I (We) have compiled the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

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

As disclosed in Note X to the financial statements, generally accepted accounting principles require that assets be presented at their estimated current values and that liabilities be presented at their estimated current amounts. James and Jane Person have informed me (us) that their investment in ABC Company is stated in the accompanying financial statements at cost and that the effects of this departure from generally accepted accounting principles on their financial condition and the changes in their net worth have not been determined.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.13.]

.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 5.20.]

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 5.09.]

.14 Accountant's Standard Review Report

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James and Jane Person as of [date], and the related statement of changes in net worth for the [period] then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James and Jane Person.

A review 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 5.11.]

.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 5.21.]

.16 Review Report—GAAP Departure—Failure to Include a Provision for Estimated Income Taxes on the Differences Between the Estimated Current Values of Assets and the Estimated Current Amounts of Liabilities and Their Tax Bases

Addressee:

I (We) have reviewed the accompanying statement of financial condition of James Person as of *[date]*, and the related statement of changes in net worth for the *[period]* then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of James Person.

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

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

Generally accepted accounting principles require that personal financial statements include a provision for estimated income taxes on the differences between the estimated current values of assets and the estimated current amounts of liabilities and their tax bases. The accompanying financial statements do not include such a provision and the effect of this departure from generally accepted accounting principles has not been determined.

[Signature]

[Date]

[Source: AICPA *Personal Financial Statements Guide*, paragraph 5.13.]

.17 Review Report—Historical Cost Basis

Addressee:

I (We) have reviewed the accompanying statement of assets and liabilities—historical cost basis of James and Jane Person as of *[date]*, and the related statement of changes in net 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 5.20.]

[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, 20X2 and 20X1, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Plan as of December 31, 20X2 and 20X1, and the changes in its financial status for the year ended December 31, 20X2 in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.04.]

Note: Department of Labor Regulations, section 2520.103-1 requires the accountant's report to be dated, manually signed, indicate the city and state where issued and identify the financial statements and schedules covered by the report.

.02 Unqualified Opinion—Defined Benefit Plan Assuming Beginning-of-Year Benefit Information Date

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statements of changes in net assets available for benefits for the years then ended and the statement of accumulated plan benefits as of December 31, 20X1, and the related statement of changes in accumulated plan benefits for the year then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, information regarding the Plan's net assets available for benefits as of December 31, 20X2, and changes therein for the year then ended and its financial status as of December 31, 20X1, and changes therein for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *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, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 20X2 and 20X1, and the changes in net assets available for benefits for the year ended December 31, 20X2 in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *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 Health Care Benefit Plan as of December 31, 20X2 and 20X1, and the related statements of changes in net assets available for benefits and of changes in benefit obligations for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Plan as of December 31, 20X2 and 20X1, and the changes in financial status for the year ended December 31, 20X2 in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.07.]

.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.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.11.]

Notes: This paragraph can be shown separately in the auditor-submitted document or as a separate paragraph, after the opinion paragraph, of the auditor's standard report, when the auditor's report covers additional information and the auditor has applied auditing procedures and is expressing an opinion on the additional information.

Examples of paragraphs that should be added to the standard auditor's report when the report on the supplemental schedules is modified because of omitted information or an omitted schedule required by DOL regulations are presented in AAM section 10,600.07, .08, and .18.

.06 Unqualified Opinion—Defined Benefit Pension Plan Prepared on the Modified Cash Basis**Independent Auditor's Report**

Addressee:

We have audited the accompanying statements of net assets available for benefits (modified cash basis) of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits (modified cash basis) for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, 20X2 and 20X1, and the changes in net assets available for benefits and changes in accumulated plan benefits for the year ended December 20X2, on the basis of accounting described in Note X.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules (modified cash basis) of (1) Schedule H, line 4i—Schedule of Assets (Held at End of Year), (2) Schedule G, Part I—Schedule of Loans or Fixed Income Obligations in Default or Classified as Uncollectible, (3) Schedule G, Part II—Schedule of Leases in Default or Classified as Uncollectible, (4) Schedule H, line 4j—Schedule of Reportable Transactions, and (5) Schedule G, Part III—Schedule of Nonexempt Transactions as of or for the year ended December 31, 20X2, are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.21.]

Note: When reporting on financial statements prepared in conformity with a basis of accounting other than generally accepted accounting principles (OCBOA), the auditor should consider whether the financial statements and notes thereto include all informative disclosures that are appropriate for the basis

of accounting used. The Interpretation, "Evaluating the Adequacy of Disclosure in Financial Statements Prepared on the Cash, Modified Cash, or Income Tax Basis of Accounting" (AU section 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 13.22.]

.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 for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) that accompanies the Plan's financial statements does not disclose the historical cost of certain nonparticipant directed plan assets held by the Plan trustee [or custodian]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

or

The Plan has not presented the supplemental Schedule H, line 4j—Schedule of Reportable Transactions. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide Audits of Employee Benefit Plans, paragraph 13.16.]

.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 supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) 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.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.16.]

.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 supplemental Schedule G, Part III—Schedule of Nonexempt Transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules [*identify*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13 17.]

** *Note:* If a material party in interest transaction that is not disclosed in the supplementary schedule is also considered a related-party transaction and if that transaction is not properly disclosed in the notes to the financial statements, the auditor should express a qualified or adverse opinion on the financial statements as well as on the supplemental schedule. See AAM section 10,600 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 supplemental Schedule G, Part III—Schedule of Nonexempt Transactions that accompanies the plan's financial statements does not disclose that the Plan *[describe prohibited transaction]*. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules 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.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.17.]

.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 supplemental Schedule G, Part III—Schedule of Nonexempt Transactions that accompanies the plan's financial statements does not disclose that the Plan [describe prohibited transaction]. Disclosure of this information, which is not considered material to the financial statements taken as a whole, is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.17.]

**.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, 20X1 and 20X0, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X1. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Plan's financial statements do not disclose that the Plan *[describe related-party transaction]*. Disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 20X1 and 20X0, and the changes in net assets available for benefits for the year ended December 31, 20X1 in conformity with accounting principles generally accepted in the United States of America.

The supplemental Schedule G, Part III—Schedule of Nonexempt Transactions that accompanies the plan's financial statements does not disclose that the plan *[describe prohibited transaction]*. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules 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.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.18.]

.13 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, 20X1 and 20X0, and for the year ended December 31, 20X1, as listed in the accompanying index. These financial statements and supplemental schedules are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing such information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of December 31, 20X1 and 20X0 and for the year ended December 31, 20X1 that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules taken as a whole. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee or custodian, have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.25.]

Note: If the plan's financial statements are prepared on the cash basis or a modified cash basis of accounting, the auditor's report should also include a paragraph stating the basis of presentation and that cash basis is a comprehensive basis of accounting other than GAAP (see paragraph 13.21 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, for wording of such a paragraph). [Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.25, footnote 6.]

.14 Limited-Scope Audit in Prior Year**Independent Auditor's Report**

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2, and the statements of accumulated plan benefits as of December 31, 20X2 and 20X1, and the related statement of changes in accumulated plan benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, investment assets held by ABC Bank, the trustee (or custodian) of the Plan, and transactions in those assets were excluded from the scope of our audit of the Plan's 20X1 financial statements, except for comparing the information provided by the trustee (or custodian), which is summarized in Note X, with the related information included in the financial statements.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the Plan's financial statements as of December 31, 20X1. The form and content of the information included in the 20X1 financial statements, other than that derived from the information certified by the trustee (or custodian), have been audited by us and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

In our opinion, the financial statements, referred to above, of XYZ Pension Plan as of December 31, 20X2, and for the year then ended present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 20X2, and changes in its financial status for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit of the Plan's financial statements as of and for the year ended December 31, 20X2, was made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of (1) Schedule H, line 4i—Schedule of Assets (Held at End of Year), (2) Schedule G, Part I—Schedule of Loans or Fixed Income Obligations in Default or Classified as Uncollectible, (3) Schedule G, Part II—Schedule of Leases in Default or Classified as Uncollectible, (4) Schedule H, line 4j—Schedule of Reportable Transactions, and (5) Schedule G, Part III—Nonexempt Transactions as of or for the year ended December 31, 20X2, are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 20X2, and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.27.]

.15 Limited-Scope Audit in Current Year**Independent Auditor's Report**

Addressee:

We were engaged to audit the accompanying statement of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2 and the supplemental schedules of (1) Schedule H, line 4i—Schedule of Assets (Held at End of Year), (2) Schedule H, line 4j—Schedule of Reportable Transactions, and (3) Schedule G, Part I—Schedule of Loans or Fixed Income Obligations in Default or Classified as Uncollectible as of or for the year ended December 31, 20X2. These financial statements and supplemental schedules are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing the information with the related information included in the 20X2 financial statements and supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of and for the year ended December 31, 20X2, that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information in the Plan's 20X2 financial statements that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules as of or for the year ended December 31, 20X2. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee (or custodian), have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

We have audited the statement of net assets available for benefits of XYZ Pension Plan as of December 31, 20X1 and, in our report dated May 20, 20X2, we expressed our opinion that such financial statement presents fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 20X1, in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.28.]

.16 Multiemployer Defined Benefit 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, 20X2 and 20X1, and for the years then ended. These financial statements are the responsibility of the Plan's management.

The Plan's records and procedures are not adequate to assure the completeness of participants' data on which contributions and benefit payments are determined, and the Board of Trustees did not engage us to perform, and we did not perform, any other auditing procedures with respect to participants' data maintained by the sponsor companies or individual participants.

Because of the significance of the information that we did not audit, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.29.]

.17 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 10,600.13.]

The supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) 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 supplemental Schedule H, line 4j—Schedule of Reportable Transactions. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee, have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.16.]

.18 Trust Established Under an Employee Benefit Plan**Independent Auditor's Report**

Addressee:

We have audited the accompanying statement of net assets of ABC Pension Trust as of December 31, 20X2, and the related statement of changes in net assets and trust balance for the year then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of ABC Pension Trust as of December 31, 20X2, and the changes in its net assets and trust balance for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying statements are those of ABC Pension Trust, which is established under XYZ Pension Plan; the statements do not purport to present the financial status of XYZ Pension Plan. The statements do not contain certain information on accumulated plan benefits and other disclosures necessary for fair presentation of the financial status of XYZ Pension Plan in conformity with accounting principles generally accepted in the United States of America. Furthermore, these statements do not purport to satisfy the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 relating to the financial statements of employee benefit plans.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.30.]

.19 Defined Benefit Plan Assuming Inadequate Procedures to Value Investments**Independent Auditor's Report**

Addressee:

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2 and 20X1 and of accumulated plan benefits as of December 31, 20X2, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X, investments amounting to \$_____ (_____ percent of net assets available for benefits) as of December 31, 20X2, have been valued at estimated fair value as determined by the Board of Trustees. We have reviewed the procedures applied by the trustees in valuing the securities and have inspected the underlying documentation. In our opinion, those procedures are not adequate to determine the fair value of the investments in conformity with accounting principles generally accepted in the United States of America. The effect on the financial statements and supplemental schedules of not applying adequate procedures to determine the fair value of the securities is not determinable.

In our opinion, except for the effects of the procedures used by the Board of Trustees to determine the valuation of investments as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 20X2, and information regarding the plan's net assets available for benefits as of December 31, 20X1, and the changes in its financial status for the year ended in December 31, 20X2 in conformity with accounting principles generally accepted in the United States of America.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of (1) Schedule H, line 4i—Schedule of Assets (Held at End of Year), (2) Schedule G, Part I—Schedule of Loans or Fixed Income Obligations in Default or Classified as Uncollectible, (3) Schedule G, Part II—Schedule of Leases in Default or Classified as Uncollectible, (4) Schedule H, line 4j—Schedule of Reportable Transactions, and (5) Schedule G, Part III—Nonexempt Transactions as of or for the year ended December 31, 20X2, are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. That additional information has been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 20X2; and in our opinion, except for the effects of the valuation of investments, as described above, the additional information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, paragraph 13.35.]

[The next page is 10,851.]

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, 20X1, and the related consolidated statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended that you are filing pursuant to rule 17a-5 under the Securities Exchange Act of 1934. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, 20X1, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix A.]

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, 20X1, and the related consolidated statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended that you are filing pursuant to rule 17a-5 under the Securities Exchange Act of 1934. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, 20X1, 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 accounting principles generally accepted in the United States of America. 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, 20X1, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 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.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix B.]

* SEC regulations require auditors to state if they have reviewed the procedures applied by the directors in valuing the securities, if they have inspected the underlying documentation, and if they believe the procedures are reasonable and documentation appropriate.

Notes: In certain circumstances, depending on materiality, the qualification could apply only to the income statement.

AAM section 10,250.150 and .160 contain illustrative reports on internal control required by SEC Rule 17a-5.

.03 Separate Report on Supplementary Schedules**Independent Auditor's Report on Supplementary Information
Required by Rule 17a-5 of the Securities and Exchange Commission**

Addressee:

We have audited the accompanying consolidated financial statements of Standard Stockbrokerage Co., Inc. and Subsidiaries as of and for the year ended December 31, 20X1, and have issued our report thereon dated February 15, 20X2. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, Appendix C.]

Note: This paragraph can be shown separately in the auditor-submitted document or as a separate paragraph, after the opinion paragraph, of the auditor's standard report.

[The next page is 10,901.]

AAM Section 10,700

Reports for Investment Companies

.01 Unqualified Opinion on the Financial Statements of a Registered Investment Company

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of investments, as of December 31, 20X4, and the related statements of operations and cash 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 financial highlights for each of the five years in the period then ended. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 20X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 20X4, the results of its operations and its cash flows* for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 11.04.]

Note: The reference to "and brokers" in the fourth sentence of the scope paragraph is not normally required if the investment company's financial statements do not show an amount payable for securities purchased. Also, if securities were "verified by examination," the report should be modified to state that.

* FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

.02 Unqualified Opinion on the Financial Statements for a Multicolumnar Presentation of the Portfolios Constituting the Series

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of assets and liabilities, including the schedules of investments, of XYZ Series Investment Company comprising the Foreign, Domestic Common Stock, Long-Term Bond, and Convertible Preferred Portfolios as of December 31, 20X4, and the related statements of operations and cash flows* for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 20X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of each of the portfolios constituting the XYZ Series Investment Company as of December 31, 20X4, the results of their operations and 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 financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 11.07.]

* FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

.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 investments, of the Convertible Preferred Portfolio (one of the portfolios constituting the XYZ Series Investment Company [the Company]) as of December 31, 20X4, and the related statements of operations and cash flows* for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 20X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of the Convertible Preferred Portfolio of the XYZ Series Investment Company as of December 31, 20X4, and the results of its operations and cash flows* for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 11.08.]

* FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

**.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 investments, as of December 31, 20X4, and the related statements of operations and cash flows* for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 20X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As explained in Note 2, the financial statements include securities valued at \$____ (____% of net assets), whose fair values have been estimated by the Board of Directors in the absence of readily ascertainable values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of fair 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 securities' estimated fair values. 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 financial highlights of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, that financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 20X4, the results of its operations and its cash flows* for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

[Signature of Firm]

[City and State]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of Investment Companies*, paragraph 11.09.]

[The next page is 11,001.]

* FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows from Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows.

AAM Section 11,000

Quality Control

These sample quality control documents are presented for illustrative purposes only. They are intended as an aid for users of this Manual who may want points of departure when establishing their own quality control policies and procedures. These illustrations are neither all inclusive nor are they prescribed minimums. Auditors and accountants should rely on professional standards and their individual professional judgment in determining what may be needed in individual circumstances.

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AAM Section 11,100

Quality Control—General

AICPA Requirements

.01 Article VI—*Scope and Nature of Services*—of the AICPA’s *Principles of Professional Conduct* (ET section 57), requires that “members 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 statements on quality control standards to give firms improved guidance for establishing and maintaining a quality control system for their accounting and auditing practices. The statements include: Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice*, as amended by SQCS No. 6, *Amendment to Statement on Quality Control Standards No. 2, System of Quality Control for a CPA Firm’s Accounting and Auditing Practice* (QC section 20), SQCS No. 3, *Monitoring a CPA Firm’s Accounting and Auditing Practice* (QC section 30), SQCS No. 4, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice* (QC section 20), and SQCS No. 5, *The Personnel Management Element of a Firm’s System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement* (QC section 40). SQCS No. 2 (QC section 20) supersedes SQCS No. 1, *System of Quality Control for a CPA Firm*, issued in 1979. SQCS No. 4 amends paragraph 18 of SQCS No. 2. SQCS No. 6 amends paragraph 3 of SQCS No. 2.

.03 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.

[The next page is 11,201.]

^{*} Currently the Audit and Attest Standards Team has a task force working on updating the Quality Control Guide. Practitioners should be alert to the issuance of a revised Guide sometime in the Fall of 2003.

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.

Note: This Guide is currently being updated to reflect the provisions of Statement on Quality Control Standard (SQCS) No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. Practitioners should be alert to the issuance of the revised Guide sometime in the Fall of 2003. In the interim, the provisions of SQCS No. 5 are enumerated in AAM section 11,250.

For handy paperback version of this guide call the AICPA Order Department at (888) 777-7077.

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.¹

.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). The personnel management element of quality control is further described in SQCS No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement*.

.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)

¹ Deficiencies in individual audit, attest, review, and compilation engagements do not, in and of themselves, indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards.

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.

* This Guide is currently being updated to reflect the provisions of Statement on Quality Control Standard (SQCS) No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. Practitioners should be alert to the issuance of the revised Guide sometime in the Fall of 2003. In the interim, the provisions of SQCS No. 5 are enumerated in AAM section 11,250. SQCS No. 5 provides additional guidance on the personnel management element of a system of quality control. As such, readers should be familiar with the requirements of SQCS No. 5.

.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. Where applicable, these policies and procedures should also address the concurring partner review requirements applicable to SEC engagements as set forth in membership requirements of the SEC Practice Section of the AICPA. 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 (SSARs). (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 partners²).
 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—

² AICPA's *Professional Standards*, volume 2, ET section 101.04, discusses circumstances when activities of a former practitioner could affect the firm's independence.

* This Guide is currently being updated to reflect the provisions of Statement on Quality Control Standard (SQCS) No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. Practitioners should be alert to the issuance of the revised Guide sometime in the Fall of 2003. In the interim, the provisions of SQCS No. 5 are enumerated in AAM section 11,250. SQCS No. 5 provides additional guidance on the personnel management element of a system of quality control. As such, readers should be familiar with the requirements of SQCS No. 5.

- 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. Where applicable, these policies and procedures should also address the concurring partner review requirements applicable to SEC engagements as set forth in membership requirements of the SEC Practice Section of the AICPA. 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. Complying with the concurring partner review requirements applicable to SEC engagements as set forth in membership requirements of the SEC Practice Section of the AICPA.**
- e. 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.
- f. 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 partners³).
 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.

³ AICPA's *Professional Standards*, volume 2, ET section 101.04, discusses circumstances when activities of a former practitioner could affect the firm's independence.

* This Guide is currently being updated to reflect the provisions of Statement on Quality Control Standard (SQCS) No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. Practitioners should be alert to the issuance of the revised Guide sometime in the Fall of 2003. In the interim, the provisions of SQCS No. 5 are enumerated in AAM section 11,250. SQCS No. 5 provides additional guidance on the personnel management element of a system of quality control. As such, readers should be familiar with the requirements of SQCS No. 5.

.75 Regional Accountants implements this policy by maintaining firm-wide hiring objectives and evaluating the firm's personnel needs, including—

- 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. Where applicable, these policies and procedures should also address the concurring partner review requirements applicable to SEC engagements as set forth in membership requirements of the SEC Practice Section of the AICPA. 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. Complying with the concurring partner review requirements applicable to SEC engagements as set forth in membership requirements of the SEC Practice Section of the AICPA.
- e. 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.
- f. 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 partners⁴).
 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.

⁴ AICPA's *Professional Standards*, volume 2, ET section 101.04, discusses circumstances when activities of a former practitioner could affect the firm's independence.

* This Guide is currently being updated to reflect the provisions of Statement on Quality Control Standard (SQCS) No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. Practitioners should be alert to the issuance of the revised Guide sometime in the Fall of 2003. In the interim, the provisions of SQCS No. 5 are enumerated in AAM section 11,250. SQCS No. 5 provides additional guidance on the personnel management element of a system of quality control. As such, readers should be familiar with the requirements of SQCS No. 5.

.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.
- 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.

* This Guide is currently being updated to reflect the provisions of Statement on Quality Control Standard (SQCS) No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. Practitioners should be alert to the issuance of the revised Guide sometime in the Fall of 2003. In the interim, the provisions of SQCS No. 5 are enumerated in AAM section 11,250. SQCS No. 5 provides additional guidance on the personnel management element of a system of quality control. As such, readers should be familiar with the requirements of SQCS No. 5.

.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.

[The next page is 11,261.]

AAM Section 11,250

SQCS No. 5, The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement

.01 SQCS No. 5 (QC section 40) clarifies the requirements of the personnel management element of a firm's system of quality control. In light of the significant responsibilities during the planning and performance of accounting, auditing, and attestation engagements of individuals who are responsible for supervising accounting, auditing, and attestation engagements and signing or authorizing an individual to sign the accountant's report on such engagements, a firm's policies and procedures related to the personnel management element of quality control should be designed to provide a firm with reasonable assurance that such individuals possess the kinds of competencies that are appropriate given the circumstances of individual client engagements. For purposes of SQCS No. 5 (QC section 40), such an individual is referred to as the practitioner-in-charge of the engagement.

Competencies

.02 Competencies are the knowledge, skills, and abilities that enable a practitioner-in-charge to be qualified to perform an accounting, auditing, or attestation engagement. A firm is expected to determine the kinds of competencies that are necessary in the individual circumstances.

Gaining Competencies

.03 A firm's policies and procedures would ordinarily require a practitioner-in-charge of an engagement to gain the necessary competencies through recent experience in accounting, auditing, and attestation engagements. In a number of cases, however, a practitioner-in-charge will have obtained the necessary competencies through disciplines other than the practice of public accounting, such as in relevant industry, governmental, and academic positions. If necessary, the experience of the practitioner-in-charge should be supplemented by continuing professional education (CPE) and consultation.

Competencies Expected in Performing Accounting, Auditing, and Attestation Engagements

.04 In practice, the kinds of competency requirements that a firm should establish for the practitioner-in-charge of an engagement are necessarily broad and varied in both their nature and number. However, the firm's quality control policies and procedures should ordinarily address the following competencies for the practitioner-in-charge of an engagement. Firm policies and procedures should also address other competencies as necessary in the circumstances.

- Understanding the role of a system of quality control and the AICPA Code of Professional Conduct
- Understanding of the service to be performed

- Technical proficiency
- Familiarity with the industry
- Professional judgment
- Understanding the organization's information technology systems

Further Guidance

.05 Readers should refer to the full text of SQCS No. 5 (QC section 40) for complete guidance and an explanation of the material presented above. SQCS No. 5 (QC section 40) was printed in the May 2000 edition of the AICPA *Journal of Accountancy* and can also be obtained at www.cpa2biz.com.

[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 11,300.23 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 Staff¹

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 when they are hired. When completing the checklist, staff are made aware that the following financial or other relationships may be prohibited:

¹ 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 11,300.06.)

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 11,300.13 and .14.)

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

^{*} This Guide is currently being updated to reflect the provisions of Statement on Quality Control Standard (SQCS) No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. Practitioners should be alert to the issuance of the revised Guide sometime in the Fall of 2003. In the interim, the provisions of SQCS No. 5 are enumerated in AAM section 11,250. SQCS No. 5 provides additional guidance on the personnel management element of a system of quality control. As such, readers should be familiar with the requirements of SQCS No. 5.

of professional development hours is maintained, updated, and periodically reviewed. (See AAM section 11,300.15–.17.) 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 11,300.22.)

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 11,300.23.) 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 11,300.25) 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 11,300.24.)

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 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 11,300.06.)

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 11,300.13.)

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 11,300.14.)

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 11,300.07.) 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.

* This Guide is currently being updated to reflect the provisions of Statement on Quality Control Standard (SQCS) No. 5, *The Personnel Management Element of a Firm's System of Quality Control—Competencies Required by a Practitioner-in-Charge of an Attest Engagement*. Practitioners should be alert to the issuance of the revised Guide sometime in the Fall of 2003. In the interim, the provisions of SQCS No. 5 are enumerated in AAM section 11,250. SQCS No. 5 provides additional guidance on the personnel management element of a system of quality control. As such, readers should be familiar with the requirements of SQCS No. 5.

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 11,300.15–.17.)

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 11,300.18–21.)

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 11,300.18.)

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 11,300.21.) 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 11,300.22.)

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 On all SEC engagements, the engagement team follows the concurring partner review requirements as set forth in the membership requirements of the SEC Practice Section of the AICPA.

2.7 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.

2.8 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 11,300.11 and .12.)

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 11,300.23.) 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 11,300.25.)
- 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 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

.07 Scheduling Request

Client _____ Engagement No. _____ Year End _____

Partner _____ Manager _____ Tax Ptr/Mgr _____

Personnel Requested	Experience Level	Interim			Year End			Total Hours
		From	Thru	Hours	From	Thru	Hours	
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____

Audited? Yes _____ No _____

SEC? Yes _____ No _____

Reviewed? Yes _____ No _____

Compiled? Yes _____ No _____

Attestation? Yes _____ No _____

Industry _____

Estimated total hours:

Partner _____

Manager _____

Staff _____

Total

Can dates be adjusted? Yes _____ No _____ Explain _____

Can personnel be changed? Yes _____ No _____ Explain _____

Comments _____

Requested by _____ Date _____ Scheduled _____ Date _____

Assignment
Manager

.08 History of Staff Assignments

NAME _____

CLIENT/ LOCATION	DATES		RESPONSIBILITY LEVEL	ASSIGNMENT DESCRIPTION				
	INTERIM	YEAR END		TOTAL HOURS	INDUSTRY	SEC	AUDIT AREAS PERFORMED	REPORTED TO
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____
_____	_____	_____	_____	_____	_____	_____	_____	_____

.10 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	X XXXXXXXX	XX XXXX	XX XXXX	XX (XX)
Evans	X	X	X	X	X	X						XXXXXXX	XX XXXX		(XX)
Frank	XX	X	X	X	X	X	X	X	X	X	X	X XXXXXXXX	XX XXXX	X 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	XXX XXX

.12 Consultation Worksheet

DATE _____

CLIENT NAME _____

LOCATION _____

ENGAGEMENT (TYPE) _____

SUBJECT (QUESTION) _____

CONSULTANT'S RESPONSE: (Cite Professional literature discussed and conclusion of consultant) _____

FINAL RESOLUTION _____

Senior/Manager_____
Date_____
Partner_____
Date

.13

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;"> NAME NAME NAME NAME </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.

.14 Interview Report

[illegible]

Note: See the AICPA MAP Handbook for an alternative.

.15 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.	_____	_____	_____	_____

.16 20XX Professional Development

Summary (in hours)				
<u>In-house presentations</u>				
	<u>Developed in-house</u>	<u>Purchased programs</u>	<u>Outside courses</u>	<u>Total</u>
Partners/Owners				
1. _____	_____	_____	_____	_____
2. _____	_____	_____	_____	_____
3. _____	_____	_____	_____	_____

<u>In-house presentations</u>				
	<u>Developed in-house</u>	<u>Purchased programs</u>	<u>Outside courses</u>	<u>Total</u>
Professional staff				
1. _____	_____	_____	_____	_____
2. _____	_____	_____	_____	_____
3. _____	_____	_____	_____	_____
4. _____	_____	_____	_____	_____
5. _____	_____	_____	_____	_____
6. _____	_____	_____	_____	_____
7. _____	_____	_____	_____	_____
8. _____	_____	_____	_____	_____

Paraprofessionals

1. _____	_____	_____	_____	_____
2. _____	_____	_____	_____	_____
3. _____	_____	_____	_____	_____
4. _____	_____	_____	_____	_____

.17 20XX Professional Development**Summary (in dollars)**

	<u>Purchased programs for in-house use</u>	<u>Outside courses</u>	<u>Total</u>
Partners/Owners			
1. _____	\$ _____	\$ _____	\$ _____
2. _____	_____	_____	_____
3. _____	_____	_____	_____
Professional staff			
1. _____	_____	_____	_____
2. _____	_____	_____	_____
3. _____	_____	_____	_____
4. _____	_____	_____	_____
5. _____	_____	_____	_____
6. _____	_____	_____	_____
7. _____	_____	_____	_____
8. _____	_____	_____	_____
Paraprofessionals			
1. _____	_____	_____	_____
2. _____	_____	_____	_____
3. _____	_____	_____	_____
4. _____	_____	_____	_____

.18 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: ☐ ☐ ☐ ☐ ☐

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: ☐ ☐ ☐ ☐ ☐

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: ☐ ☐ ☐ ☐ ☐

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: ☐ ☐ ☐ ☐ ☐

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: ☐ ☐ ☐ ☐ ☐

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 _____

.19

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	3-	C+	C
SUPERIOR	EXCELLENT	ABOVE AVERAGE	SATISFACTORY	IMPROVEMENT DESIRED	IMPROVEMENT REQUIRED	UNSATISFACTORY
NOT APPLICABLE						

A. PERFORMANCE ON THE JOB1. *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

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Knowledge and Skill Form

(and Profile of Management Role Performance)

Staff member evaluated			Date					
Evaluator			<p><i>Indicate most effective and least effective roles by placing a check in the far left or right hand column (maximum of two each). For the other five traits, indicate relative strength of staff member by placing a check in columns 2, 3, or 4.</i></p>					
			If you wish, add your own words.	Effectiveness				
				Least		Most		
				1	2	3	4	5
Planner								
Careful	Sloppy	Thorough						
Imaginative	Foresighted	Infrequent						
Routine	Erratic	Last-minute						
Constant	Cautious	Meticulous						
Problem solver								
Analytical	Consistent	Superficial						
Critical	Faulty	Routine						
Hasty	Creative	Reliable						
Slow	Quick	Successful						
Communicator								
Warm	Sloppy	Cold						
Inhibited	Weak	Unstructured						
Thorough	Receptive	Patient						
Expressive	Efficient	Precise						
Leader								
Dominating	Excitable	Partial						
Uncertain	Permissive	Energetic						
Weak	Fair	Heavy-handed						
Loose	Amiable	Sure						
Decision maker								
Decisive	Lone	Delayer						
Slow	Avoider	Reliable						
Quick	Seldom	Participative						
Frequent	Rash	Dependent						
Trainer								
Systematic	Unprepared	Conscientious						
Patient	Efficient	Knowledgeable						
Sloppy	Diligent	Disinterested						
Off-on	Slow	Enthusiastic						
Team member								
Cooperative	Unreliable	Independent						
Influential	Divisive	Undisciplined						
Conformist	Reliable	Contributing						
Forceful	Reluctant	Welcome						
Innovator								
Original	Appropriate	Consistent						
Infrequent	Clever	Sensible						
Unnecessary	Creative	Unimaginative						
Constant	Disruptive	Rash						
Job expertise								
Amateur	Improving	Too technical						
Obsolete	Mediocre	Disinterested						
Masterful	Balanced	Lagging						
Versatile	Up-to-date	Thorough						

(Complete Annually)

.21 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 All			2 = Met Most	
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 & ACKNOWLEDGEMENT
<p>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 <input type="checkbox"/> do not <input type="checkbox"/> feel it should be revised. My signature and the date I discussed this with the preparer appears below.</p>

Employee	Date
Evaluator/Title	Date

.22 Client/Engagement Acceptance and Continuation Checklist³

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?) _____

³ 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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.24 Summary Monitoring/Inspection Report**I. *Planning the Inspection***

A. Inspection period _____

B. Composition of Inspection Team:

1. Captain _____ Position _____

2. Team Member _____ Position _____

3. Team Member _____ Position _____

C. Indicate matters that may require additional emphasis in the inspection and explain why.

D. Development of Inspection Program:

1. Describe programs used and indicate any deviations therefrom.

2. Describe basis for selection of engagements:

E. Timing of Inspection:

Commencement _____

Completion of work _____

Issuance of report _____

II. *Scope of Work Performed*

A. Indicate elements of quality control not addressed and give reasons.

B. Engagements Reviewed:

	Firm Totals		Engs. Reviewed	
	Hrs.	No. of Engs.	Hrs.	No. of Engs.
Audits:				
SEC Clients				
Government ¹				
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.

Supervisory Partner _____
Date _____

¹ Includes only audits conducted pursuant to the *Government Auditing Standards*, issued by the Comptroller General of the United States ("yellow book").

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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	
Auditing Standards Statement on Auditing Standards No. 94, <i>The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit</i>	Audits of financial statement for periods beginning on or after 6/1/01					
Attestation Standards						
Auditing Interpretations						
Attestation Interpretations						
Standards for Accounting and Review Services						
Other AICPA Official Releases Statement of Position 01-2, <i>Accounting and Reporting by Health and Welfare Benefit Plans</i>	Financial statements for plan years beginning after 12/15/00					
Other Professional Pronouncements 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	
Financial Accounting Standards Board <i>Statement No. 139, Rescission of FASB Statement No. 53 and amendments to FASB Statements No. 63, 89, and 121</i>	Years beginning after 12/15/00					
Governmental Accounting Standards Board						
Other Pronouncements						

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[The next page is 12,001.]

AAM Section 12,000

State and Local Governments

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Note: This edition of the Audit and Accounting Manual has *not* been revised for the effects of the following Governmental Accounting Standards Board (GASB) pronouncements:

- Statement No. 34, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments*
- Statement No. 35, *Basic Financial Statements—and Management’s Discussion and Analysis—for Public Colleges and Universities*
- Statement No. 37, *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments: Omnibus*
- Interpretation No. 6, *Recognition and Measurement of Certain Liabilities and Expenditures in Governmental Fund Financial Statements*

GASB Statement No. 34, as amended by GASB Statement No. 35 and 37, fundamentally changes the format and content of financial statements (the financial reporting model) for all governmental entities. GASB Interpretation No. 6 clarifies the application of modified accrual recognition in governmental funds. The effective date to implement the requirements of GASB Statement No. 34, as amended, and, simultaneously, GASB Interpretation No. 6, is based on the total annual revenues of a government’s governmental and enterprise funds. See the AICPA Audit Risk Alert, *State and Local Governmental Developments—2003*, for further information about these standards. The Risk Alert is in AAM section 8070.

This edition of the Audit and Accounting Manual also has *not* been revised for the AICPA Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*, which addresses the audits of financial statements prepared using the provisions of GASB Statement No. 34, as amended.

A future AICPA Practice Aid will consider the effects of the above cited GASB pronouncements and AICPA Audit and Accounting Guide on the materials in this State and Local Governments section of the Audit and Accounting Manual.

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[The next page is 12,051.]

AAM Section 12,010

*Internal Control Form— Governmental Units*¹

.01 This section and AAM sections 12,020 and 12,030 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.^{2,3} 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 the caution at 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.⁴

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

¹ The Governmental Accounting Standards Board (GASB) has issued several pronouncements that will make significant changes in how most state and local governmental entities account for and report on their transactions and balances in the future. In addition, the AICPA Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*, addresses the audits of financial statements prepared in conformity with those GASB pronouncements. This form does not incorporate changes that might be needed as a result of those GASB pronouncements or that Guide. See the discussion of those GASB pronouncements, that Guide, and the planned AICPA Practice Aid in the headnote in AAM section 12,000.

² Neither this section nor AAM sections 12,020 or 12,030 specifically address internal control considerations for audits conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States. For such considerations, the auditor is advised to see AAM section 12,350, *Government Auditing Standards Requirements*, chapters 4 and 5 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, and the AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.

³ 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*.

⁴ 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.

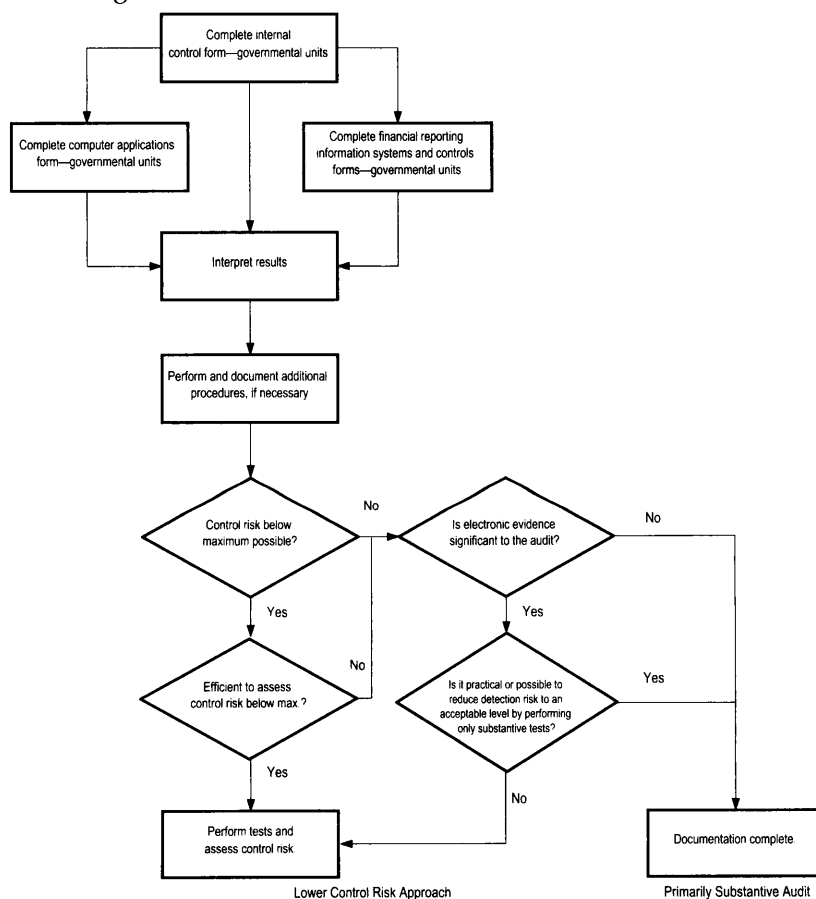
- Identify specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions, and
- Perform tests of controls to evaluate their effectiveness.

The form at AAM section 12,030 identifies the financial statement assertions to which those specific controls apply.

.06 In situations where significant 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 especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form.) 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 results of operations.

.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.

.11 SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU section 316), establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Issued in October 2002 and effective for audits of financial statements for periods beginning on or after December 15, 2002, the requirements of SAS No. 99 (AU section 316) will affect the auditor's consideration of internal control. For example, paragraph 20 of SAS No. 99 (AU section 316.20) requires auditors to ask management about programs and controls the entity has established to mitigate specific fraud risks the entity has identified, or that otherwise help to prevent, deter, and detect fraud, and how management monitors those programs and controls. Appendix A to chapter 3 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, describes the requirements of SAS No. 99 (AU section 316) and discusses government-specific considerations.

Documenting a Conclusion

.12 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.

.13 If the completion of this form is not sufficient for you to obtain the necessary level of understanding discussed in paragraph .10 above, you should perform and document the results of additional procedures to gain that level of understanding.

.14

I. Document Your Understanding of the Control Environment

In the space provided below, indicate whether you strongly agree, somewhat agree, somewhat disagree, or strongly disagree with the following statements 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>
A. Control Environment					
<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>
<i>Commitment to Competence</i>					
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.	_____	_____	_____	_____	_____
<i>Governing Board and Audit Committee</i>					
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. Uncorrected audit adjustments.	_____	_____	_____	_____	_____
d. Significant comments and recommendations.	_____	_____	_____	_____	_____
e. 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.	_____	_____	_____	_____	_____
<i>Management's Philosophy and Operating Style</i>					
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.	_____	_____	_____	_____	_____
Organizational Structure					
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.	_____	_____	_____	_____	_____
<i>Assignment of Authority and Responsibility</i>					
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.	_____	_____	_____	_____	_____
<i>Human Resource Policies and Practices</i>					
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. Risk Assessment					
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.	_____	_____	_____	_____	_____
C. General Control Activities					
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.	_____	_____	_____	_____	_____
8. There is general ledger control over all assets and transactions of all departments of the entity.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
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 encumbrance or other 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.	_____	_____	_____	_____	_____
20. The entity considers the applicable provisions of laws, regulations, grants, and contracts in establishing its general control activities.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
D. Information and Communication					
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 legal and contractual provisions, 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. This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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. (See paragraph .06.) 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.

	No	Yes	W/P References
Computers or Outside Computer Service Bureaus⁵			
1. The entity uses computers or outside computer service bureaus to process significant accounting information (see form at AAM section 12,020).			
Significant Account Balances and Transaction Cycles			
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.) ⁶			
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.

⁵ Governments also often use service organizations other than computer service bureaus. For example, governments use service organizations to invest bond proceeds and pension plan assets, to serve as third party administrators for employee health insurance programs, and to collect taxes. Sometimes services organizations may be other governments. For example, a county may collect property taxes for cities, towns, villages, and school districts within the county and a state may collect income and sales taxes for other governments within the state. When an entity obtains services from another organization and those services are part of the entity's information system, SAS No. 70, *Service Organizations*, as amended by SAS No. 88, *Service Organizations and Reporting Consistency* (AU section 324), provides guidance to the auditor about the situations in which and how to consider the effect of the service organization's controls on user organization's controls. The AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* also provides guidance. The Audit Guide can be obtained by calling the AICPA Order Department at 1-888-777-7077 and asking for product number 012772.

⁶ SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU section 316), requires the auditor ordinarily to presume that there is a risk of material misstatement due to fraud relating to revenue recognition and to provide specific documentation if the auditor does not identify improper revenue recognition as a risk of material misstatement due to fraud in a particular circumstance. SAS No. 99 (AU section 316) is effective for audits of financial statements for periods beginning on or after December 15, 2002, with early application permitted.

- How substantive procedures will be designed to limit the risk of those misstatements to an acceptable level.

IV. Assess the Risk of Management Override

Even in effectively controlled entities—those with generally high levels of integrity and control consciousness—a manager might be able to override controls. The term “management override” means overruling prescribed policies or procedures for *illegitimate* purposes with the intent of personal gain or enhanced presentation of an entity’s financial condition or compliance status.

Management might override the control system for many reasons: to increase reported revenue 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 or contractual 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. This assessment should come, in part, from the results of discussions among the audit team members, as required by SAS No. 99 (AU section 316), about the susceptibility of the entity’s financial statements to material misstatement due to fraud. You should consider the risk that management override possibilities exist, the risk that management will take advantage of those possibilities, and any evidence that management has engaged in override practices. If the risk of management override is greater than low, indicate how planned audit procedures will reduce this risk to an acceptable level.

V. Interpret Results

You should consider the *collective* effect of the strengths and weaknesses in various control components. Management’s strengths and weaknesses may have a pervasive effect on internal control. For example, management controls may mitigate a lack of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by management to overstate results of operations.

	20__	20__	20__	20__
Prepared or updated by:	_____	_____	_____	_____
Reviewed by:	_____	_____	_____	_____

[The next page is 12,091.]

only for significant account balances and transaction cycles. See *Financial Reporting Information Systems and Control Forms—Governmental Units* [AAM section 12,030].)

	<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>
Acquisition of Hardware					
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.	_____	_____	_____	_____	_____
Acquisition of Software					
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.	_____	_____	_____	_____	_____
Program Development					
12. Users are involved in the design and approval of systems.	_____	_____	_____	_____	_____
13. Users review the completion of various phases of the application.	_____	_____	_____	_____	_____
14. New programs are thoroughly tested.	_____	_____	_____	_____	_____
15. Users are involved in the review of tests of the program.	_____	_____	_____	_____	_____

	<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.	_____	_____	_____	_____	_____
Program Changes					
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.	_____	_____	_____	_____	_____
Logical Access					
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.	_____	_____	_____	_____	_____
Physical Security					
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.	_____	_____	_____	_____	_____
Data Processing Operations					
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>
Training					
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, *Service Organizations* (AU section 324), as amended. The AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* also provides guidance. The Audit Guide can be obtained by calling the AICPA Order Department at 1-888-777-7077 and asking for product number 012772.

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.

20__ 20__ 20__ 20__

Prepared or updated by: _____

Reviewed by: _____

[The next page is 12,100-31.]

AAM Section 12,030

Financial Reporting Information Systems and Control Forms—Governmental Units^{1, 2}

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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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

¹ Neither this section nor AAM sections 12,010 or 12,020 specifically address internal control considerations for audits conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States. For such considerations, the auditor is advised to see AAM section 12,350, *Government Auditing Standards Requirements*, chapters 4 and 5 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, and the AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.

² The Governmental Accounting Standards Board (GASB) has issued several pronouncements that will make significant changes in how most state and local governmental entities account for and report on their transactions and balances in the future. In addition, the AICPA Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*, addresses the audits of financial statements prepared in conformity with those GASB pronouncements. These forms do not incorporate changes that might be needed as a result of those GASB pronouncements or that Guide. See the discussion of those GASB pronouncements, that Guide, and the planned AICPA Practice Aid in the headnote in AAM section 12,000.

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>
I. Budget Preparation				
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)	_____	_____	_____	_____
II. Budget Approval				
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)	_____	_____	_____	_____
III. Budget Accounting and Reporting				
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)	_____	_____	_____	_____

Procedures and Controls Over End User Computing

.10 Answer the following questions relating to procedures and controls over end user computing related to the budgetary process.

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
Budgetary Processes				
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.

20__ 20__ 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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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 Receivable³

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)

<i>Personnel</i>	<i>N/A</i>	<i>No</i>	<i>Yes</i>
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_____ **NAME** _____ **DATE** _____

³ For grants received, see also AAM section 12,030.29, item III

	<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. Taxes				
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. Controls exist to recognize property tax receivables and revenues in the proper period in conformity with generally accepted accounting principles based on the entity's enforceable legal claim to the amounts, time requirements, and resource "availability," as appropriate. (P)	_____	_____	_____	_____
28. Self-assessed tax returns are cross-referenced against a database of previous taxpayers. (C)	_____	_____	_____	_____
29. Self-assessed tax returns are reviewed for mathematical accuracy. (E, C, R, V)	_____	_____	_____	_____
30. Self-assessed tax refund claims are reviewed and approved. (E, C, R, V)	_____	_____	_____	_____
31. Self-assessed tax returns are audited to provide reasonable assurance that taxable transactions are properly reported. (E, C, R, V)	_____	_____	_____	_____
32. Controls exist to recognize self-assessed tax receivables and revenues in the proper period in conformity with generally accepted accounting principles based on when the underlying exchange transaction occurs and resource "availability," as appropriate. (P)	_____	_____	_____	_____
33. 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)	_____	_____	_____	_____

	<i>Personnel</i>	<i>N/A</i>	<i>No</i>	<i>Yes</i>
34. Controls exist to ensure that tax exemptions are within the law and properly approved. (E, C, R, V)	_____	_____	_____	_____
35. Tax exemption and relief programs are periodically reviewed and approved by the governing board. (C, R, V)	_____	_____	_____	_____
C. Usage Fees and Service Charges				
36. Controls ensure that the customer database and usage records are accurately maintained so that all amounts due are billed. (E, C, R, V)	_____	_____	_____	_____
37. If billing is based on usage, service readings are performed in a timely fashion. (E, C, R)	_____	_____	_____	_____
38. Assignments of meter readers are periodically rotated. (E, C, R)	_____	_____	_____	_____
39. Procedures exist to identify and investigate unusual patterns of use. (E, C)	_____	_____	_____	_____
40. There are controls for extending credit to customers, such as a written policy and supervisory review of such situations. (R, V)	_____	_____	_____	_____
D. Fines and License Fees				
41. Records of payments due are maintained and used as a basis for collections. (E, C, R, V)	_____	_____	_____	_____
42. Controls exist surrounding the issuance and disposition of traffic violations to ensure that amounts due are assessed and collected. (E, C, R, V)	_____	_____	_____	_____
43. Procedures exist correlate amounts collected with records of court proceedings. (E, C, R, V)	_____	_____	_____	_____
44. Tickets for fines, arrests, and so forth are sequentially numbered and satisfactorily accounted for. (E, C)	_____	_____	_____	_____
45. Licenses are sequentially numbered and satisfactorily accounted for. (E, C)	_____	_____	_____	_____
46. If annual payments are involved, procedures exist to ensure that previous years' records are properly updated for new registrants and withdrawals. (E, C, R)	_____	_____	_____	_____
47. Controls exist to recognize fine and fee receivables and revenues in the proper period in conformity with generally accepted accounting principles based on the underlying exchange, the entity's enforceable legal claim to the amounts, time requirements, and resource "availability," as appropriate. (P)	_____	_____	_____	_____
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)	_____	_____	_____	_____

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

.21 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 (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.

Procedures and Controls Over End User Computing

.22 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>
Revenue Cycle				
1. End user applications listed in paragraph .21 of this form have been adequately tested before use.	_____	_____	_____	_____
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	_____	_____	_____	_____
3. Access controls limit access to the end user application.	_____	_____	_____	_____
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	_____	_____	_____	_____
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	_____	_____	_____	_____

Information Processed by Outside Computer Service Organizations

.23 *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 revenue cycle.

.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.

20__

20__

20__

20__

Prepared or updated by:

Reviewed by:

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 budgetary and 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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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>
I. Purchases and Accounts Payable				
A. Initiating Purchases and Receipts of Goods				
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 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. Processing Purchases				
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. Comparing invoice quantities, prices, and terms with those indicated on the purchase order. (E, C, V)	_____	_____	_____	_____
c. Comparing 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)	_____	_____	_____	_____

<i>Personnel</i>	<i>N/A</i>	<i>No</i>	<i>Yes</i>
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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)

_____	_____	_____	_____
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_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
III. Grants Received and Made⁴				
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)	_____	_____	_____	_____
16. Procedures exist to monitor recipient compliance with grant terms. (C, P)	_____	_____	_____	_____

⁴ 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>
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)	_____	_____	_____	_____
22. Controls exist to recognize grant receivables, revenues, expenditures/expenses, and payables in the proper period in conformity with generally accepted accounting principles based on the underlying exchange, the receipt of the resources, the entity's enforceable legal claim to the amounts, time requirements, and resource "availability," as appropriate. (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 source of the information used in the application.
- How the results of the application are used in further processing or decision making.

Procedures and Controls Over End User Computing

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

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

Information Processed by Outside Computer Service Organizations

.35 *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 purchasing cycle.

.36 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.

	20__	20__	20__	20__
Prepared or updated by:				
Reviewed by:				

Cash and Investments^{5, 6}

.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

⁵ SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AU section 332), provides guidance in planning and performing auditing procedures for assertions about those items. SAS No. 92 (AU section 332) explains that the auditor may need special skill or knowledge to plan and perform auditing procedures for certain assertions about derivatives and securities. It also provides guidance on obtaining an understanding of internal control, assessing inherent and control risk, and designing substantive procedures. The AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product number 012520), is an essential companion guide to SAS No. 92 (AU section 332). The guide provides practical guidance and case studies for implementing SAS No. 92 (AU section 332). To order the guide call the AICPA Order Department at 888-777-7077.

⁶ Generally accepted accounting principles (GAAP) require fair value measurements and disclosures for many investments and investment-related transactions. In January 2003, the AICPA Auditing Standards Board (ASB) issued SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AU section 328), to establish standards and provide guidance on auditing fair value measurements and disclosures in financial statements. SAS No. 101 (AU section 328) is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application is permitted.

accessed electronically, just gaining an understanding of internal control may not be enough (even in a primarily substantive approach). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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.

.41

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
I. Cash and Investments				
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)	_____	_____	_____	_____
II. Cash				
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)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
6. Bank statements and paid warrants or checks are delivered in unopened envelopes directly to the employee preparing the reconciliation. (E, C, V)	_____	_____	_____	_____
7. Procedures exist for steps essential to an effective bank statement reconciliation, particularly—				
a. Comparison of warrants or checks in appropriate detail with disbursement records. (C, V)	_____	_____	_____	_____
b. Examination of signature and endorsements, at least on a test basis. (E, R)	_____	_____	_____	_____
c. Accounting for numerical sequence of warrants or checks used. (C)	_____	_____	_____	_____
d. Comparison of book balances used in reconciliations with general ledger accounts. (E, C, V)	_____	_____	_____	_____
e. Comparison of deposit amounts and dates with cash receipt entries. (C, V)	_____	_____	_____	_____
f. 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)	_____	_____	_____	_____

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
8. Responsibilities for initiating investment transactions are segregated from those for final approvals that commit government resources. (E)	_____	_____	_____	_____
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 for cash and investments. 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.

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>
Cash and Investments				
1. End user applications listed in paragraph .45 of this form have been adequately tested before use.	<div></div>	<div></div>	<div></div>	<div></div>
2. The application has an appropriate level of built-in controls, such as edit checks, range tests, or reasonableness checks.	<div></div>	<div></div>	<div></div>	<div></div>
3. Access controls limit access to the end user application.	<div></div>	<div></div>	<div></div>	<div></div>
4. A mechanism exists to prevent or detect the use of incorrect versions of data files.	<div></div>	<div></div>	<div></div>	<div></div>
5. The output of the end user applications is reviewed for accuracy or reconciled to the source information.	<div></div>	<div></div>	<div></div>	<div></div>

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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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.

.53

	<u>Personnel</u>	<u>N/A</u>	<u>No</u>	<u>Yes</u>
I. Fixed Assets				
A. Authorization and Initiation				
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)	_____	_____	_____	_____
C. Dispositions				
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.

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>
Fixed Assets				
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:

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). This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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.

.65

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

	<i>Personnel</i>	<i>N/A</i>	<i>No</i>	<i>Yes</i>
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).

- The source of the information used in the application.
- How the results of the application are used in further processing or decision making.

This image shows a single sheet of white paper with horizontal blue or grey ruling lines. The lines are evenly spaced and run across the width of the page. There is no handwriting or other markings on the paper.

Procedures and Controls Over End User Computing

.70 Answer the following questions relating to procedures and controls over end user computing related to the payroll cycle.

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

.72 In the space below, describe the payroll 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:

[The next page is 12,100-101.]

AAM Section 12,040

Internal Control Checklist—Federal Awards (OMB Circular A-133 Single Audits)

.01 The A-102 Common Rule and OMB Circular A-110, *Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals, and Nonprofit Organizations*, require 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*¹ 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 Part 6 of the March 2003 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.

¹ For the requirements of *Government Auditing Standards* issued by the Comptroller General of the United States, see AAM section 12,350, *Government Auditing Standards Requirements*, chapters 4 and 5 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, and the AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
A. Control Environment					
1. The entity has a sense of conducting operations ethically, as evidenced by a code of conduct or other verbal or written directive.	_____	_____	_____	_____	_____
2. The governing Board has established an Audit Committee or equivalent that is responsible for engaging the auditor, receiving all reports and communications from the auditor, and ensuring that audit findings and recommendations are adequately addressed.	_____	_____	_____	_____	_____
3. Management has responded positively to prior questioned costs and control recommendations.	_____	_____	_____	_____	_____
4. Management has respect for and adheres to program compliance requirements.	_____	_____	_____	_____	_____
5. Key managers' responsibilities are clearly defined.	_____	_____	_____	_____	_____
6. Key managers have adequate knowledge and experience to discharge their responsibilities.	_____	_____	_____	_____	_____
7. Staff is knowledgeable about compliance requirements and are given responsibility to communicate all instances of noncompliance to management.	_____	_____	_____	_____	_____
8. Management's commitment to competence ensures that staff receives adequate training to perform their duties.	_____	_____	_____	_____	_____
9. Management supports adequate information and reporting systems.	_____	_____	_____	_____	_____
B. Risk Assessment					
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.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
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.	_____	_____	_____	_____	_____
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.	_____	_____	_____	_____	_____
C. Control Activities					
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>
9. The governing Board conducts regular meetings, for which written documentation is maintained, where financial information is reviewed and the results of program activities and accomplishments are discussed.	_____	_____	_____	_____	_____
D. Information and Communication					
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.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
E. Monitoring					
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.	_____	_____	_____	_____	_____
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.	_____	_____	_____	_____	_____
7. The governing Board reviews the results of all monitoring or audit reports and periodically assesses the adequacy of corrective action.	_____	_____	_____	_____	_____

.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. _____

	<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. There is a process for assessing risks resulting from changes to cost accounting systems.	_____	_____	_____	_____	_____
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.	_____	_____	_____	_____	_____
6. Monitoring—					
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.	_____	_____	_____	_____	_____
C. Cash Management					
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.	_____	_____	_____	_____	_____

D. Davis-Bacon Act

1. *Control objectives*—To provide reasonable assurance that contractors and subcontractors were properly notified of the Davis-Bacon Act requirements and the required certified payrolls were submitted to the non-Federal entity.
2. *Control Environment*—
 - a. Management understands and communicates to staff, contractors, and subcontractors the requirements to pay wages in accordance with the Davis-Bacon Act.

	_____	_____	_____	_____	_____
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 - b. Management understands its responsibility for monitoring compliance.

	_____	_____	_____	_____	_____
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3. *Risk Assessment*—
 - a. Mechanisms are in place to identify contractors and subcontractors that are the most at risk of noncompliance.

	_____	_____	_____	_____	_____
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 - b. Management has identified how compliance will be monitored and the related risks of failure to monitor for compliance with Davis-Bacon Act.

	_____	_____	_____	_____	_____
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	<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. Contractors are informed in the procurement documents of the requirements for prevailing wage rates.	_____	_____	_____	_____	_____
b. Contractors and subcontractors are required by contract to submit certifications and copies of payrolls.	_____	_____	_____	_____	_____
c. Contractors' and subcontractors' payrolls are monitored to ensure certified payrolls are submitted.	_____	_____	_____	_____	_____
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 to report noncompliance.	_____	_____	_____	_____	_____
6. Monitoring—					
a. Management performs reviews to ensure that contractors and subcontractors are properly notified of the Davis-Bacon Act requirements.	_____	_____	_____	_____	_____
b. Management performs reviews to ensure that certified payrolls are properly received.	_____	_____	_____	_____	_____

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. *Control objectives*—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. *Control Environment*—
 - 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>
I. Procurement and Suspension and Debarment					
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.	_____	_____	_____	_____	_____
5. Information and Communication—					
<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. Procurement staff are provided a current <i>List of Parties Excluded from Federal Procurement or Non-procurement Programs</i> , issued by the General Services Administration, or have on-line access.	_____	_____	_____	_____	_____
d. 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.	_____	_____	_____	_____	_____
J. Program Income					
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. Control Environment—					
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. Risk Assessment—					
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. Control Activities—					
a. Pricing and collection policies procedures are clearly communicated to personnel responsible for program income.	_____	_____	_____	_____	_____

	<u>No Opinion</u>	<u>Strongly Disagree</u>	<u>Some- what Disagree</u>	<u>Some- what Agree</u>	<u>Strongly Agree</u>
b. Mechanism are in place to ensure that program income is properly recorded as earned and deposited in the bank as collected.	_____	_____	_____	_____	_____
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. 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.	_____	_____	_____	_____	_____
c. 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.^{1,2} 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, and illegal acts that have a direct and material effect on the financial statements.³
- 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.

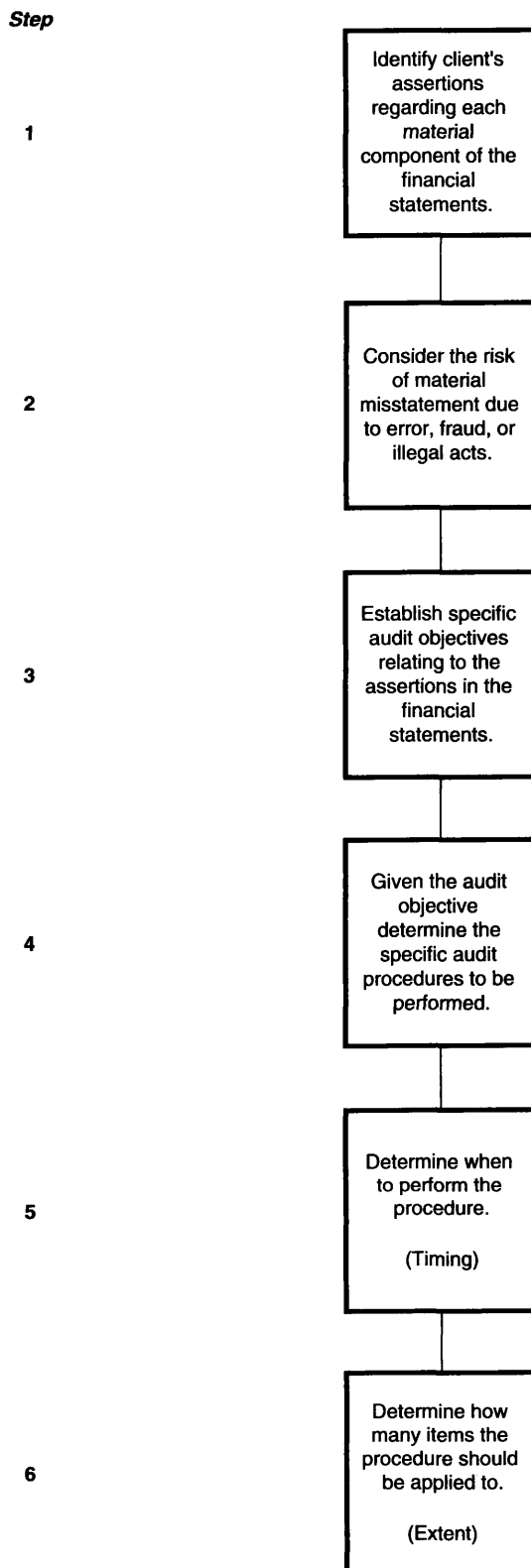
¹ The AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition) (With Conforming Changes as of May 1, 2003)*, paragraph 3.12, states that audit scope should be set and materiality evaluations should be applied at the fund type, account group, and discretely presented component unit column(s) when reporting on the general purpose financial statements (GPFS), or at the individual fund statement level when reporting on the GPFS and combining and individual fund financial statements in a comprehensive annual financial report (CAFR). However, that guidance changes in the AICPA Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)* as a result of the issuance of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. See the discussion of GASB Statement No. 34 and that Guide in the headnote in AAM section 12,000.

² 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 AAM section 12,350, *Government Auditing Standards Requirements*, chapters 4 and 5 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, the AICPA Audit Guide *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."*

³ Auditing Interpretation 1 of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 9312.01-.04), defines a misstatement as something that causes the financial statements not to be in conformity with generally accepted accounting principles (GAAP). Misstatements may consist of (1) difference between the amount, classification, or presentation of a reported financial statement element, account, or item and the amount, classification, or presentation that would have been reported under GAAP, (2) the omission of a financial statement element, account, or item, (3) a financial statement disclosure that is not presented in accordance with GAAP, or (4) the omission of information required to be disclosed in accordance with GAAP.

.04 The six steps illustrated in flowchart 1 result in a determination of the nature, timing, and extent of audit tests.

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 entity 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 and SAS No. 94 (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. This is especially the case when evidence of an entity's initiation, recording, or processing of financial data exists only in electronic form. 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. (See SAS No. 31, as amended [AU section 326.12–.14 and .25].)

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*, as amended (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.
- 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:⁴

- 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, as amended (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

⁴ SAS No. 96, *Audit Documentation* (AU section 339), amends SAS No. 56, *Analytical Procedures* (AU section 329), to require specific audit documentation when an analytical procedure is used as the principal substantive test of a significant financial statement assertion.

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 22, 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 Auditors 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,⁵ 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

⁵ See footnote 1.

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 governing board 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

Note: The Governmental Accounting Standards Board (GASB) has issued several pronouncements that will make significant changes in how most state and local governmental entities account for and report on their transactions and balances in the future. In addition, the AICPA Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*, addresses the audits of financial statements prepared in conformity with those GASB pronouncements. These audit programs do not incorporate changes that might be needed as a result of those GASB pronouncements or that Guide. See the discussion of those GASB pronouncements, that Guide, and the planned AICPA Practice Aid in the headnote in AAM section 12,000.

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>
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I. Engagement Planning and Administration¹

A. Engagement Planning Procedures

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. _____

¹ This program only addresses 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 AAM section 12,350, *Government Auditing Standards Requirements*. This audit program also does not address compliance audits of state, local, or nongovernmental grants. See the AICPA's Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards (with conforming changes as of May 1, 2003)*, paragraphs 3.54 through 3.56 for a brief discussion of some of the considerations in auditing such grants.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
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.	_____	_____	_____
j. Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. ²	_____	_____	_____
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.	_____	_____	_____

² See AAM section 12,100, footnote 1.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
b. Determine whether the required communications in SAS No. 84, <i>Communications Between Predecessor and Successor Auditors</i> [AU section 315], as amended, 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 audit documentation.	_____	_____	_____
d. If the predecessor auditor provides an acknowledgment letter, determine whether our firm has signed and returned it, and file a copy in the audit documentation.	_____	_____	_____
e. Prepare a list of prior year audit documentation needed for review and communicate the list to the predecessor auditor.	_____	_____	_____
f. Make arrangements for review of prior year audit documentation.	_____	_____	_____
g. Document the results of the review of prior year audit documentation.	_____	_____	_____
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. ³	_____	_____	_____
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 principal 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.	_____	_____	_____

³ See footnote 1.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
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 audit documentation.	_____	_____	_____
13. Based on a review of the prior-year reports, financial statements, and audit documentation; the permanent file; interim financial statements and preliminary financial information for the current year; 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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
14. Review the prior year audit documentation and the permanent file, particularly the following:			
a. Internal control questionnaires, memoranda, and related summary evaluation notes.	_____	_____	_____
b. Engagement time summary records.	_____	_____	_____
c. Adjusting and reclassification entries.	_____	_____	_____
d. Uncorrected financial statement misstatements included in or with the prior-period representation letter and communicated to the audit committee.	_____	_____	_____
e. Memoranda regarding consultations on accounting and auditing matters.	_____	_____	_____
f. Suggestions for the next audit.	_____	_____	_____
g. 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 audit 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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
j. The nature and amount of the entity's related party transactions that require disclosure in the financial statements.	_____	_____	_____
k. Significant legal matters and contingencies, including environmental remediation liabilities.	_____	_____	_____
l. Known violations of legal and contractual provisions.	_____	_____	_____
m. Debt covenants and any known violations of them.	_____	_____	_____
n. Disposition of prior year management letter points, reportable conditions, and findings and questioned costs.	_____	_____	_____
o. Closing information to be prepared, such as closing journal entries and post-closing trial balance.	_____	_____	_____
p. Assistance to be provided by entity personnel.	_____	_____	_____
q. Timing of preliminary audit work, inventory observation, confirmation procedures, final audit work, and so forth.	_____	_____	_____
r. Adequacy of working space for the audit team.	_____	_____	_____
s. Access to entity records, including the entity's working hours and holidays and vacations scheduled by key personnel.	_____	_____	_____
t. The effect of new accounting and auditing pronouncements on the entity.	_____	_____	_____
u. 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. Obtain preliminary financial information from the entity for the period under audit.	_____	_____	_____
a. Compute planning materiality at the appropriate level (fund type and account group or individual fund). ⁴	_____	_____	_____
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. (See also Step 25b.)	_____	_____	_____

⁴ See AAM section 12,100, footnote 1.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
23. Consider factors influencing the risks of material misstatements in the financial statements due to errors, fraud, or illegal acts and assess and document those risks and their effect on the audit. (See Appendix A to chapter 3 in the AICPA Audit Guide <i>Audits of State and Local Governmental Units (Non-GASB 34 Edition)</i> , as well as other steps in this audit program relating to the risks of material misstatement due to fraud.) Factors to consider may include the following:			
a. The existence of laws, rules, and regulations that may have a direct and material effect on 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. 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.	_____	_____	_____
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.	_____	_____	_____
24. Hold discussion among engagement personnel, including the engagement partner, regarding the risks of material misstatement due to fraud that:			
a. Considers how and where the entity's financial statements might be susceptible to material misstatement due to fraud, and how we might respond to that susceptibility.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
b. Considers how the entity's management could perpetrate and conceal fraudulent financial reporting.	_____	_____	_____
c. Considers how the entity's assets could be misappropriated.	_____	_____	_____
d. Reinforces the importance of adopting an appropriate mind-set of professional skepticism.	_____	_____	_____
25. Obtain information to use to identify the risks of material misstatement due to fraud by:			
a. Asking management and others within the entity (including the audit committee and internal auditors) about fraud or suspected fraud; allegations of fraud or suspected fraud; the risks of fraud; programs and controls established to prevent and detect fraud; whether management has communicated information about those programs and controls to the audit committee; and how management communicates to employees its views on business practices and ethical behavior.	_____	_____	_____
b. Considering unusual or unexpected relationships identified through planning and analytical procedures.	_____	_____	_____
c. Considering fraud risk factors in the following categories: ⁵			
(1) Incentives or pressure to perpetrate fraud.	_____	_____	_____
(2) Opportunities to carry out the fraud.	_____	_____	_____
(3) Attitude or rationalization to justify the fraudulent action.	_____	_____	_____
d. Considering other information, such as that obtained when deciding to accept the engagement or to retain the client and when assessing inherent risks for account balances or transaction classes, that may help identify risks of material misstatement due to fraud.	_____	_____	_____
26. Use the information gathered in the previous step to identify risks that may result in a material misstatement due to fraud by considering the types of risks that may exist, the significance of the risks, the likelihood of the risks, and the pervasiveness of the risks. (Note that paragraph 41 of SAS No. 99 [AU section 316.14], states that ordinarily auditors should presume a risk of material misstatement due to fraud relating to revenue recognition.)	_____	_____	_____
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			

⁵ Appendix A, in chapter 3 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, and the AICPA Practice Aid, *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*, provide government-specific example of fraud risk factors.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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 risks 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, and the consistency with which they were applied, and who applied them. Audit documentation relating to the tests should describe the policies and procedures tested, test objectives, sample selection, test criteria, test results, and conclusions concerning the effectiveness of the control activity being tested.	_____	_____	_____
(c) Document conclusions in the audit documentation concerning the assessed level of control risk for the assertion.	_____	_____	_____
28. 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, including procedures to address the risk of material misstatement due to fraud involving management override of controls.	_____	_____	_____
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.)	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
29. Prepare an audit planning memorandum for review and approval by the audit partner that includes:			
a. Audit approach.	_____	_____	_____
b. Use of analytical procedures.	_____	_____	_____
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.	_____	_____	_____
30. Discuss the audit plan with the engagement personnel. Have them review the planning memorandum.	_____	_____	_____
31. Schedule timing of work to be done on priority basis, assigning top priorities to more significant or problem areas of engagement.	_____	_____	_____
32. Prepare a listing of schedules/analyses to be prepared by the entity (and audit documentation 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 audit documentation is marked "Prepared by Client" or "PBC".	_____	_____	_____
B. Engagement Administration and Supervision Procedures⁶			
1. Accumulate all points concerning internal control related matters to be communicated to the entity (SAS No. 60, as amended by SAS Nos. 78 and 87 [AU section 325]).	_____	_____	_____

⁶ 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>
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. Obtain written representations from management (see AAM section 12,200.140, Step A4).	_____	_____	_____
3. 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.	_____	_____	_____
4. 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.	_____	_____	_____
5. Determine whether all audit documentation has been headed, indexed, cross-referenced, initialed, and dated.	_____	_____	_____
6. Clear all pending items, and dispose of all follow-up or "TO DO" sheets and any other similar notations in the files.	_____	_____	_____
7. Review financial statements and notes and:			
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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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 audit documentation.	_____	_____	_____
8. Evaluate whether the accumulated results of audit procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit.	_____	_____	_____
a. Have the engagement partner ascertain whether there has been appropriate communication about the risks of material misstatement due to fraud among team members throughout the audit.	_____	_____	_____
9. Determine whether audit documentation:			
a. Includes appropriate memoranda regarding consultations with firm specialists, outside consultations, and resolution of differences of opinion, if any, among firm personnel regarding accounting/auditing matters.	_____	_____	_____
b. Shows that the accounting records agree or reconcile with the financial statements or other information being reported on.	_____	_____	_____
c. Includes abstracts or copies of significant contracts or agreements that were examined to evaluate the accounting for significant transactions.	_____	_____	_____
d. Includes an identification of the items tested, for tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation.	_____	_____	_____
e. Documents audit findings and issues that are significant, actions taken to address them, and the basis for the final conclusions reached.	_____	_____	_____
10. 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.			
a. Determine whether the audit documentation includes the nature and effect of the aggregated misstatements, and a conclusion as to whether the aggregated misstatements cause the financial statements to be materially misstated. ⁷	_____	_____	_____
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 presented in the auditor's report.	_____	_____	_____

⁷ See AAM section 12,100, footnote 1

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
12. If audit tests identify significant misstatements in the financial statements, determine that consideration was given to whether such misstatements may be indicative of fraud and that appropriate action was taken. (See AU section 316.77).	_____	_____	_____
13. 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].)	_____	_____	_____
14. 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.	_____	_____	_____
15. 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.	_____	_____	_____
16. 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.	_____	_____	_____
d. Include in the audit documentation the conditions or events that led to the belief that there is substantial doubt about the entity's ability to continue as a going concern; the work performed to evaluate management's plans; a conclusion as to whether substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains or is alleviated; and the consideration and effect of that conclusion on the financial statements.	_____	_____	_____
17. 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 audit documentation to that effect (SAS No. 61, as amended by SAS No. 89 [AU section 380]):			
a. The auditors' responsibility under generally accepted auditing standards.	_____	_____	_____

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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|--|-------|-------|-------|
| 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. Uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole. ⁸ | _____ | _____ | _____ |
| f. The auditor's responsibility for other information in documents containing audited financial statements (such as a comprehensive annual financial report). | _____ | _____ | _____ |
| g. Disagreements with management. | _____ | _____ | _____ |
| h. Consultations by management with other accountants about auditing and accounting matters. | _____ | _____ | _____ |
| i. Major issues discussed with management prior to retention. | _____ | _____ | _____ |
| j. Difficulties encountered in performing the audit. | _____ | _____ | _____ |
| k. If this communication is in writing, determine whether it includes restricted use language as provided by SAS No. 87. | _____ | _____ | _____ |
| 18. 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 _____

⁸ See AAM section 12,100, footnote 1.

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 any excesses of expenditures over appropriations in individual funds and material violations of budgetary laws and regulations have been adequately disclosed in the notes to the financial statements. (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)

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>
A. Audit Procedures to Test Budgetary Information				
[A] [D]	1. Discuss with management the applicable statutes and ordinances governing the legal status of the budget and its applicability to the various funds of the governmental entity.	_____	_____	_____
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. Audit Procedures to Test Budgetary Compliance and Reporting				
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 actual and budget amounts in the entity's budgetary report to its accounting records on a test basis.	_____	_____	_____
D	3. Determine whether the following are disclosed in the notes to the financial statements:			
	a. Any excesses of expenditures over appropriations in individual funds.	_____	_____	_____
	b. Material violations of budgetary laws and regulations and actions taken to address those violations. ¹	_____	_____	_____
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.	_____	_____	_____

¹ The disclosure of remedial actions is a requirement of GASB Statement No. 38, *Certain Financial Statement Note Disclosures*, which is not required to be implemented until the government implements GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. However, earlier implementation is encouraged.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
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)

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.

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. This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	determined 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.	_____	_____	_____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	_____	_____	_____
B. Analytical Procedures				
	1. Review the planning procedures applicable to analytical procedures performed on cash and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	_____	_____	_____
	2. If an analytical procedure is used as the principal substantive test of a significant financial statement assertion, document:			
	a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.	_____	_____	_____
	b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.	_____	_____	_____
	c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.	_____	_____	_____
C. Other Auditing Procedures¹				
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 [see AAM section 7200.03].	_____	_____	_____
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.	_____	_____	_____

¹ In March 2003, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 40, *Deposit and Investment Risks Disclosures*, an amendment of GASB Statement No. 3, to address disclosures for deposit and investment risks. That Statement modifies and eliminates certain disclosures required by GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*. GASB Statement No. 40 is effective for audits of financial statements for fiscal years beginning after June 15, 2004. Earlier application is permitted. Certain of these procedures will require modification if the entity has applied the provisions of GASB Statement No. 40.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
	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. ²	_____	_____	_____

D. Overall Conclusions

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

² 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^{1, 2, 3}****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)

¹ 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.

² SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AU section 332), provides guidance in planning and performing auditing procedures for assertions about those items. SAS No. 92 (AU section 332) explains that the auditor may need special skill or knowledge to plan and perform auditing procedures for certain assertions about derivatives and securities. It also provides guidance on obtaining an understanding of internal control, assessing inherent and control risk, and designing substantive procedures. The AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product number 012520), is an essential companion guide to SAS No. 92 (AU section 332). The guide provides practical guidance and case studies for implementing SAS No. 92 (AU section 332). To order the guide, call the AICPA Order Department at 888-777-7077.

³ Generally accepted accounting principles (GAAP) require fair value measurements and disclosures for many investments and investment-related transactions. In January 2003, the AICPA Auditing Standards Board (ASB) issued SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AU section 328), to establish standards and provide guidance on auditing fair value measurements and disclosures in financial statements. SAS No. 101 (AU section 328) is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application is permitted.

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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)			
<p>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.</p>			
A. Evaluation of Internal Control			
1. Review the understanding of internal control over investments and investment transactions and the preliminary assessment of control risk.			
2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk. This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has determined 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.			
3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.			
B. Analytical Procedures			
1. Review the planning procedures applicable to analytical procedures performed on investments and related income and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.			
2. If an analytical procedure is used as the principal substantive test of a significant financial statement assertion, document:			
a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.			
b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.			
c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.			

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
C. Other Auditing Procedures⁴				
[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 documentation and general ledger, respectively.	_____	_____	_____
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.	_____	_____	_____

⁴ In March 2003, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 40, *Deposit and Investment Risks Disclosures*, an amendment of GASB Statement No. 3, to address disclosures for deposit and investment risks. That Statement modifies and eliminates certain disclosures required by GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*. GASB Statement No. 40 is effective for audits of financial statements for fiscal years beginning after June 15, 2004. Earlier application is permitted. Certain of these procedures will require modification if the entity has applied the provisions of GASB Statement No. 40.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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>Service Organizations</i> , as amended by SAS No. 88, or SAS No. 73, <i>Using the Work of a Specialist</i> .	_____	_____	_____
	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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
	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, <i>Accounting and Financial Reporting for Certain Investments and for External Investment Pools</i> .	_____	_____	_____
[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.)	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____
	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			

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	GASB Technical Bulletin 94-1, <i>Disclosures about Derivatives and Similar Debt and Investment Transactions</i> . ⁵	_____	_____	_____
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> .	_____	_____	_____

D. Overall Conclusions

1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:
 - a. Investments reported in the financial statements 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.
 - 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

⁵ In March 2003, the GASB staff released proposed Technical Bulletin (TB) 2003-a, *Disclosure Requirements for Derivatives Not Presented at Fair Value on the Statement of Net Assets*, to supersede GASB Technical Bulletin No. 94-1, *Disclosures about Derivatives and Similar Debt and Investment Transactions*. The proposed TB would require note disclosure of the nature of derivative transactions not reported at fair value on the statement of net assets, and their significant terms, fair values, risks, and associated debt. The GASB staff expects to finalize the proposed TB as GASB Technical Bulletin 2003-1 by June 2003. It would be effective for financial statements for periods ending after June 15, 2003, with earlier application encouraged.

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.**V. Receivables and Revenues—Governmental Funds¹****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 measurement, presentation, and disclosure of receivables and revenue 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.

A. Evaluation of Internal Control

1. Review the understanding of internal control over receivable and revenue transactions and the preliminary assessment of control risk.

¹ Interest income is addressed in the program at AAM section 12,200.040.

<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. This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has determined 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.	_____	_____	_____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	_____	_____	_____
B. Analytical Procedures				
	1. Review the planning procedures applicable to analytical procedures performed on receivables and revenue and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	_____	_____	_____
	2. If an analytical procedure is used as the principal substantive test of a significant financial statement assertion, document:			
	a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.	_____	_____	_____
	b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.	_____	_____	_____
	c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.	_____	_____	_____
C. Other Auditing Procedures—Receivables and Revenues—Governmental Funds				
1. General				
[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 audit documentation and the entity's general ledger.	_____	_____	_____
2. General Property Taxes				
[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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A B D	d. Review the entity's policy for recognizing property tax receivables and revenue to determine whether it conforms to GAAP for nonexchange transactions.	_____	_____	_____
B D	e. For current-year taxes levied, recalculate the tax levy and compare to the recorded receivables (in total and by fund).	_____	_____	_____
B D	f. For current-year taxes not yet levied, review the reasonableness of the recorded receivables (in total and by fund).	_____	_____	_____
A B D	g. Test property tax receipts to determine whether the amounts:			
	(1) Recognized as revenues were levied to finance the current or a prior fiscal year and were received during the fiscal year or the entity's "availability" period.	_____	_____	_____
	(2) Reduced the recorded taxes receivable.	_____	_____	_____
A B D	h. Review allowance for uncollectible taxes for reasonableness and compare to prior year's computation. Obtain explanation for any unusual changes. Determine that uncollectible amounts are reported in the financial statements or the notes thereto.	_____	_____	_____
A D	i. Determine that deferred revenue has been recorded for collectible property tax receivables that have not yet been recognized as revenues.	_____	_____	_____
A B	j. Determine whether tax sales were properly authorized for nonpayment of taxes and that revenues and reductions of receivables were properly recorded.	_____	_____	_____
D	k. Determine whether property tax policies and procedures are properly disclosed in the notes to financial statements.	_____	_____	_____
B	l. Consider confirming property tax receivables.	_____	_____	_____
3. Sales Taxes				
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	b. Compare current year's actual revenue with the current year's budget and prior year's actual revenue; explain any unusual fluctuations or variances.	_____	_____	_____
A B D	c. Review the entity's policy for recognizing sales tax receivables and revenue to determine whether it conforms to GAAP for nonexchange transactions.	_____	_____	_____
A B D	d. Test sales tax receipts to determine whether the amounts:			
	(1) Recognized as revenues relate to sales made during the current or a prior fiscal year and received during the fiscal year or the entity's "availability" period.	_____	_____	_____
	(2) Reduced the recorded taxes receivable, if applicable.	_____	_____	_____

[The next page is 12,231.]

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A B D	e. Determine whether sales taxes receivables and deferred taxes are properly recorded at fiscal year end:			
	(1) Review the entity's methods for estimating the receivable accrual for taxes for sales made by year end but not yet recognized as revenues.	_____	_____	_____
	(2) Compare the current-year receivable accrual to the prior-year receivable accrual and investigate unusual items.	_____	_____	_____
	(3) Recalculate deferred revenue as the amount of the receivables reduced by amounts recognized as revenues.	_____	_____	_____
A B C	f. 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 properly recorded in the accounting records.	_____	_____	_____
4. Income and Other Self Assessed Taxes				
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	b. Compare current year's actual revenue with the current year's budget and the prior year actual revenue; explain any unusual fluctuations or variances.	_____	_____	_____
A B D	c. Review the entity's policy for recognizing income and other self-assessed tax receivables and revenue to determine whether it conforms to GAAP for nonexchange transactions.	_____	_____	_____
A B D	d. Test tax receipts to determine whether the amounts:			
	(1) Recognized as revenues relate to taxable events and transactions that took place during the current or a prior fiscal year and received during the fiscal year or the entity's "availability" period.	_____	_____	_____
	(2) Reduced the recorded taxes receivable, if applicable.	_____	_____	_____
A B D	e. Determine whether taxes receivables, tax refund liabilities, and deferred taxes are properly recorded at fiscal year end:			
	(1) Review the entity's methods for estimating the tax receivable accrual for taxes for taxable events and transactions that took place by year end but not yet recognized as revenues.	_____	_____	_____
	(2) Review the entity's methods for estimating the tax refund liability.	_____	_____	_____
	(3) Compare the current-year receivable and liability accruals to the prior-year receivable and liability accruals and investigate unusual items.	_____	_____	_____
	(4) Recalculate deferred revenue as the amount of the receivables reduced by amounts recognized as refund liabilities and revenues.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A B D	f. Select a sample of returns and verify that the taxpayer's liability was computed in accordance with governing laws and regulations and that related payments were properly recorded in the accounting records.	_____	_____	_____
5. Revenue From Grants and Contributions				
A B D	a. Review the entity's policy for recognizing receivables and revenue from grants and contributions to determine whether it conforms to GAAP for exchange and exchange-like transactions, government-mandated nonexchange transactions, and voluntary nonexchange transactions, including that revenue recognition considers the "availability" of the resources.	_____	_____	_____
[A] [B] C [D]	b. Review grant and contribution applications, agreements, contracts, budgets, and reports to determine applicable eligibility requirements and purpose restrictions.	_____	_____	_____
[A] [B] C [D]	c. Review the reasonableness of the entity's indirect cost allocation plan.	_____	_____	_____
A B C D	d. Test revenue and receivables from grants and contributions to determine whether:			
	(1) Amounts recognized conform to the entity's recognition policies.	_____	_____	_____
	(2) Applicable eligibility requirements affecting recognition were met.	_____	_____	_____
A B C D	e. Test expenditures from grants and contributions (including indirect cost allocations) to determine whether:			
	(1) Purpose restrictions were met.	_____	_____	_____
	(2) Other material compliance requirements were met.	_____	_____	_____
A B C D	f. Concerning compliance with provider stipulations:			
	(1) Review grant and contribution records and correspondence files for areas of material noncompliance and questioned costs.	_____	_____	_____
	(2) Determine whether the entity has adjusted receivables (or liabilities) and revenues (or expenditures/expenses) for grants and contributions for which provider stipulations have not or will not be met. (The accounts to be adjusted depend on the period in which the noncompliance is identified).	_____	_____	_____
A C D	g. 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 B	h. Confirm grant and contribution receipts and receivables with grantors and contributors.	_____	_____	_____
A B D	i. Determine whether pass-through grants are appropriately accounted for.	_____	_____	_____
D	j. Determine whether grant and contribution receivables and revenues are properly classified in the financial statements.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
6. Licenses and Permits				
[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 B D	c. Review the entity's policy for recognizing receivables and revenue from licenses and permits to determine whether it conforms to GAAP for exchange and exchange-like transactions and for nonexchange transactions (as appropriate), including that revenue recognition considers the "availability" of the resources.	_____	_____	_____
A B D	d. Test receivables and revenue from licenses and permits to determine whether amounts recognized conform to the entity's recognition policies.	_____	_____	_____
A C	e. 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.	_____	_____	_____
7. Franchise Fees				
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.	_____	_____	_____
A B D	c. Review the entity's policy for recognizing receivables and revenue from franchise fees to determine whether it conforms to GAAP for exchange and exchange-like transactions and for nonexchange transactions (as appropriate), including that revenue recognition considers the "availability" of the resources.	_____	_____	_____
A B D	d. Test receivables and revenue from franchise fees to determine whether amounts recognized conform to the entity's recognition policies.	_____	_____	_____
A B	e. Consider confirming franchise fees received or receivable during the year directly with the franchisee.	_____	_____	_____
8. Fines				
[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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A	b. Compare fine revenue by totals to current year's budget and prior year actual revenue. Explain any unusual fluctuations or variations.	_____	_____	_____
A B D	c. Review the entity's policy for recognizing receivables and revenue from fines to determine whether it conforms to GAAP for nonexchange transactions, including that revenue recognition considers the "availability" of the resources.	_____	_____	_____
A B D	d. Test receivables and revenue from fines to determine whether amounts recognized conform to the entity's recognition policies.	_____	_____	_____
A C	e. Determine whether fines are distributed in accordance with governing regulations.	_____	_____	_____
9. Sale of Property and Equipment				
[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.	_____	_____	_____
A B C D	b. Determine whether proceeds are credited to the proper fund as required by law, that any receivables are properly classified, and that amounts are supported by source documents.	_____	_____	_____
	c. Determine whether dispositions have been removed from the property and equipment records.	_____	_____	_____
10. Rentals of Property and Equipment				
[A] [C]	a. Examine authorizing laws and regulations, schedules, contracts, leases, and other documents governing the use of public property by others.	_____	_____	_____
A B C	b. On a test basis, compare the amounts of billings against terms of rental agreements.	_____	_____	_____
A 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.	_____	_____	_____
11. Special Assessments				
[A] C	a. Examine minutes of the governing body for authorization of special assessments.	_____	_____	_____
A B D	b. Review the entity's policy for recognizing receivables and revenue from special assessments to determine whether it conforms to GAAP for exchange or nonexchange transactions (as appropriate), including that revenue recognition considers the "availability" of the resources.	_____	_____	_____
A B D	c. Test receivables and revenue from special assessments to determine whether amounts recognized conform to the entity's recognition policies.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	d. 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 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.	_____	_____	_____
12. Other Revenues				
A B C D	a. Schedule any other revenue accounts of material amount and perform audit procedures determined necessary.	_____	_____	_____
D. Other Auditing Procedures—Receivables—Governmental Funds				
1. Accounts Receivables²				
	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.	_____	_____	_____
2. All Receivables				
B	a. Obtain an aged listing of receivables 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.	_____	_____	_____

² SAS No. 67, *The Confirmation Process* (AU section 330), defines accounts receivable as the entity's claims against customers that have arisen from the sale of goods or services in the normal course of business.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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 receivables written off during the year and of all credits issued during the year, and review for authority and propriety.	_____	_____	_____
B	e. Review collectibility of receivables with responsible personnel and determine whether a proper allowance is established for uncollectible receivables.	_____	_____	_____

E. Overall Conclusions

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)
 - d. Financial statement measurement, 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.

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Obj.Done
ByDateW/P
Ref.**VI. Expenditures, Expenses, Payables, and Prepaid Items¹****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.

¹ See also the audit programs at AAM sections 12,200.080 and 12,200.120 concerning capital expenditures and risk financing and insurance related activities, respectively.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
A. Evaluation of Internal Control				
	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. This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has determined 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.	_____	_____	_____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	_____	_____	_____
B. Analytical Procedures				
	1. Review the planning procedures applicable to analytical procedures performed on expenditures/expenses, payables, and prepaid items and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	_____	_____	_____
	2. If an analytical procedure is used as the principal substantive test of a significant financial statement assertion, document:			
	a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.	_____	_____	_____
	b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.	_____	_____	_____
	c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.	_____	_____	_____
C. Other Auditing Procedures				
	1. Expenditures/Expenses in General			
[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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	(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.	_____	_____	_____
	(8) That discounts were taken when offered.	_____	_____	_____
	(9) The check was signed by an authorized person.	_____	_____	_____
	(10) If the expenditure/expense was for an exchange transaction, that it was recorded in the period the good or services were received (except for those items that are capitalized, for example, as prepaid items).	_____	_____	_____
	(11) If the expenditure/expense was for a nonexchange transaction, that it was recorded in the period that the recipient met the provider's eligibility requirements (if resources have been transmitted but the eligibility requirements have not been met, those amounts should be recorded as advances).	_____	_____	_____
	(12) 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). ²	_____	_____	_____
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 B E	e. Determine whether the entity has adjusted liabilities (or receivables) and expenditures/expenses (or revenues) for nonexchange transactions for which its stipulations have not or will not be met. (The accounts that should be adjusted depend on the period in which the noncompliance is identified).	_____	_____	_____
A F	f. Schedule any other expenditure/expense accounts of material amount or unusual nature and perform audit procedures determined necessary.	_____	_____	_____
F	g. 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.	_____	_____	_____

² 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>
A F	h. Compare individual expenditure/expense accounts to current year's budget and prior year's actual. Explain any unusual fluctuations or variations.	_____	_____	_____
	2. Liabilities in General			
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.	_____	_____	_____
	b. Deposit Liabilities:			
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.	_____	_____	_____
	c. Taxes Levied or Collected for Other Governments:			
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	(2) Obtain a sample of collections during the period and trace into the accounting records.	_____	_____	_____
B F	(3) Determine whether balances on hand are recorded as liabilities due to other governments.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
B	(4) Trace material amounts to settlements in subsequent period.	_____	_____	_____
	<i>d.</i> Taxes Collected Under Protest:			
B F	(1) Obtain listing of taxes collected under protest and reconcile to amounts recorded as such liabilities in the general ledger.	_____	_____	_____
B	(2) Vouch 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.	_____	_____	_____
	<i>e.</i> Escheat Liabilities:			
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.	_____	_____	_____
3. Payroll and Payroll Taxes				
	<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). ³	_____	_____	_____
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.	_____	_____	_____

³ See footnote 2.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
E	(3) If payroll tax payments were charged to grant programs, determine whether the costs were allowable and otherwise complied with program requirements. ⁴	_____	_____	_____
B E	c. 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	d. Compare payroll and payroll tax accounts to budgeted amounts and to prior year's actual. Explain any unusual variations or fluctuations.	_____	_____	_____
A B E	e. 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.	_____	_____	_____
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> .	_____	_____	_____
4. Employee Fringe Benefits				
[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: ⁵			
	(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.	_____	_____	_____

⁴ See footnote 2.

⁵ 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>
A B F	<p>c. For compensated absences, obtain the entity's computation of its liability and determine by appropriate tests that:</p> <p>(1) The schedule is arithmetically correct.</p> <p>(2) All qualifying employees are included and that all employees included on the schedule are qualified.</p> <p>(3) Appropriate pay or salary rates are applied.</p> <p>(4) Leave balances shown on the schedule are reasonable and are consistent with leave records of selected employees.</p> <p>(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.</p> <p>(6) The schedule is correct as to the employing fund.</p> <p>(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>.</p> <p>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.⁶</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>
A B C F	<p>(1) Determine by appropriate tests that:</p> <p>(a) The schedule is arithmetically correct.</p> <p>(b) The information in the schedule is consistent with the actuarial valuation.</p> <p>(c) Annual contributions reconcile to actual disbursements.</p> <p>(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>.</p> <p>(e) The details of the schedule reconcile to general ledger amounts.</p> <p>(f) Amounts have been accounted for in the proper fund or in the general long-term debt account group.</p> <p>(g) Amounts recognized as pension expenditures/expenses, liabilities, and assets are in conformity with generally accepted accounting principles.</p> <p>(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.</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>	<p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p> <p>_____</p>

⁶ 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.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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], as amended.	_____	_____	_____
	(b) Obtain an understanding of the actuary's methods and assumptions.	_____	_____	_____
	(c) Submit an inquiry to the actuary concerning: ⁷			
	(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.	_____	_____	_____
	(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			

⁷ See the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, 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>
	with program requirements (such as that the amounts charged were based on amounts paid or amounts measured on a GAAP-basis, if applicable). ⁸	_____	_____	_____
	5. Postemployment Benefits Other Than Pension Benefits (OPEB)			
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.	_____	_____	_____
F	c. Review the entity's OPEB disclosures in the notes to financial statements for conformity with generally accepted accounting principles.	_____	_____	_____
	6. Special Termination Benefits			
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.	_____	_____	_____
	7. Municipal Solid Waste Landfill Closure and Postclosure Care Costs			
[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], as amended, 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> .	_____	_____	_____

⁸ See footnote 2.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	8. Encumbrances and Other Commitments			
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.	_____	_____	_____
D F	d. Determine whether encumbrances and other significant commitments have been properly reported and disclosed in the financial statements.	_____	_____	_____
	9. Prepaid Items			
[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):	_____	_____	_____

C F	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.	_____	_____	_____
	D. Overall Conclusions			
	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.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
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)

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.

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. This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has determined 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. _____

<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. Analytical Procedures				
	1. Review the planning procedures applicable to analytical procedures performed on inventories and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	_____	_____	_____
	2. If an analytical procedure is used as the principal substantive test of a significant financial statement assertion, document:			
	a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.	_____	_____	_____
	b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.	_____	_____	_____
	c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.	_____	_____	_____
C. Other Auditing Procedures				
A B	1. Observe the taking of physical inventories.	_____	_____	_____
	a. Review client's arrangements for the physical inventory, paying particular attention to controls to ensure completeness of the physical count.	_____	_____	_____
	b. Make test counts of various items, recording description and quantities of items selected.	_____	_____	_____
	c. Inspect inventory for evidence of damaged items and/or obsolete goods and determine that such stock has been appropriately identified in the inventory count.	_____	_____	_____
	d. Inspect inventory for unusual concentration or overstocking of particular items, unusual storage that could cause difficult or impossible counts 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	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
C	5. Select several items included in the inventory test counts and verify prices to determine that the inventory has been consistently valued.	_____	_____	_____
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:

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

Date

Done by _____

Reviewed by _____

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.080

Obj.Done
ByDateW/P
Ref.

VIII. Capital Expenditures and Related Fund and Account Group Activity¹
(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)

¹ See also the audit program at AAM section 12,200.060 for auditing procedures relating to cash disbursements and payables for capital expenditures.

<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><i>Note:</i> 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>			
A. Evaluation of Internal Control			
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. This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has determined 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.	_____	_____	_____
3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	_____	_____	_____
B. Analytical Procedures			
1. Review the planning procedures applicable to analytical procedures performed on capital expenditures and capital assets and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	_____	_____	_____
2. If an analytical procedure is used as the principal substantive test of a significant financial statement assertion, document:			
a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.	_____	_____	_____
b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.	_____	_____	_____
c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.	_____	_____	_____
C. Other Auditing Procedures—Capital Expenditures			
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
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). ²	_____	_____	_____
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.	_____	_____	_____
D. Other Auditing Procedures—Leases				
[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.	_____	_____	_____

² 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>
	c. Trace unpaid lease amounts to general long term debt account group (GLTDAG).	_____	_____	_____
B	5. Examine documentary support for lease payments.	_____	_____	_____
G	6. If lease expenditures were charged to grant programs, determine whether the costs were allowable and otherwise complied with program requirements. ³	_____	_____	_____
E	7. Determine whether the disclosures about operating and capital leases in the notes to the financial statements are in conformity with GAAP.	_____	_____	_____
E. Other Auditing Procedures—GFAAG				
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.	_____	_____	_____
D	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. ⁴	_____	_____	_____
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.	_____	_____	_____

³ See footnote 2.⁴ See footnote 2.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
F	7. Determine whether property transfers between the GFAAG and proprietary funds are appropriately reported.	_____	_____	_____

F. Overall Conclusions

1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:
 - a. Property and equipment recorded in the GFAAG 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, is 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^{1,2}****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 measurement, 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)

¹ SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AU section 332), provides guidance in planning and performing auditing procedures for assertions about those items. SAS No. 92 (AU section 332) explains that the auditor may need special skill or knowledge to plan and perform auditing procedures for certain assertions about derivatives and securities. It also provides guidance on obtaining an understanding of internal control, assessing inherent and control risk, and designing substantive procedures. The AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product number 012520), is an essential companion guide to SAS No. 92 (AU section 332). The guide provides practical guidance and case studies for implementing SAS No. 92 (AU section 332). To order the guide, call the AICPA Order Department at 888-777-7077.

² In March 2003, the GASB staff released proposed Technical Bulletin (TB) 2003-a, *Disclosure Requirements for Derivatives Not Presented at Fair Value on the Statement of Net Assets*, to supersede GASB Technical Bulletin No. 94-1, *Disclosures about Derivatives and Similar Debt and Investment Transactions*. The proposed TB would require note disclosure of the nature of derivative transactions not reported at fair value on the statement of net assets, and their significant terms, fair values, risks, and associated debt. The GASB staff expects to finalize the proposed TB as GASB Technical Bulletin 2003-1 by June 2003. It would be effective for financial statements for periods ending after June 15, 2003, with earlier application encouraged.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
<p>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.</p>				
A. Evaluation of Internal Control				
	1. Review the understanding of internal control over debt and debt service transactions and the preliminary assessment of control risk.	_____	_____	_____
	2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk. This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has determined 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.	_____	_____	_____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	_____	_____	_____
B. Analytical Procedures				
	1. Review the planning procedures applicable to analytical procedures performed on debt and debt service and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	_____	_____	_____
	2. If an analytical procedure is used as the principal substantive test of a significant financial statement assertion, document:			
	a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.	_____	_____	_____
	b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.	_____	_____	_____
	c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.	_____	_____	_____
C. Other Auditing Procedures—Short-term Obligations				
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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
D. Other Auditing Procedures—Bonds				
C	1. Examine provisions of bond ordinances and tax levies for retirement of bond principal and interest and test compliance therewith, including: <ul style="list-style-type: none"> 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: <ul style="list-style-type: none"> a. Trace amounts maturing currently to expenditure/expense accounts for interest and principal. b. Trace unmaturing 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: <ul style="list-style-type: none"> 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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
D	8. Determine whether the entity's accounting, financial reporting, and disclosures for the bonds are in conformity with GAAP.	_____	_____	_____
E. Other Auditing Procedures—Long-term Obligations Other Than Bonds				
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.	_____	_____	_____
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.	_____	_____	_____
F. Other Auditing Procedures—Federal Arbitrage Requirements and Arbitrage Refund Liabilities³				
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	_____	_____	_____

³ 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*.

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
bond issues for failure to comply with federal arbitrage restriction and rebate requirements.	_____	_____	_____
G. Other Audit Procedures			
D 1. Determine whether conduit debt obligations are disclosed 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> .	_____	_____	_____
H. Overall Conclusions			
1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
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 measurement, 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.

.100

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 measurement, 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)

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.

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. This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has determined 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.	_____	_____	_____
3.	Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	_____	_____	_____
B. Analytical Procedures				
1.	Review the planning procedures applicable to analytical procedures performed on interfund transactions and fund equity and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	_____	_____	_____
2.	If an analytical procedure is used as the principal substantive test of a significant financial statement assertion, document:			
a.	The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.	_____	_____	_____
b.	Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.	_____	_____	_____
c.	Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.	_____	_____	_____
C. Other Auditing Procedures—Interfund Transactions				
[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.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
D. Other Auditing Procedures—Fund Equity			
B 1. Review minutes of the governing body, charter, and debt issu- ance 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 contrac- tual provisions, including purpose restrictions on nonexchange transaction resources, 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.	_____	_____	_____
E. Overall Conclusions			
1. In our opinion, we have obtained sufficient and competent evi- dential matter to provide reasonable assurance that:			
a. Interfund transactions and changes in reserved, designated, and undesignated fund equity reported in the financial state- ments 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 accord- ance with legal and contractual provisions.	_____	_____	_____
d. Financial statement measurement, presentation, and disclo- sure of interfund and fund equity transactions and balances are in conformity with generally accepted accounting prin- ciples (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.

.110

Obj.Done
ByDateW/P
Ref.

XI. Proprietary Funds—Special Topics

Note: Most of the audit procedures applicable to proprietary funds will be completed in connection with other audit programs. However, certain types of accounts and transactions found in proprietary funds have been separately addressed in this program.

Financial Statement Assertions

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

Audit Objectives

- A. 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)

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>
	A. Evaluation of Internal Control			
	1. Review the understanding of internal control over proprietary fund revenues, receivables, grant financed fixed assets, and contributed capital 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. This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has determined 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.	_____	_____	_____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	_____	_____	_____
	B. Analytical Procedures			
	1. Review the planning procedures applicable to analytical procedures performed on proprietary fund revenues, receivables, 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 an analytical procedure is used as the principal substantive test of a significant financial statement assertion, document:			
	a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.	_____	_____	_____
	b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.	_____	_____	_____
	c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.	_____	_____	_____
	C. Other Auditing Procedures—Operating Revenues			
[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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	(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 allocate costs to each customer.	_____	_____	_____
	(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.	_____	_____	_____
D. Other Auditing Procedures—Receivables				
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 accounts receivables are not confirmed, however, the reason for nonconfirmation must be documented. (See AAM section 12,200.050, footnote 1.) 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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
E. Other Auditing Procedures—Grant Financed Fixed Assets				
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). ¹	_____	_____	_____
F. Other Auditing Procedures—Contributed Capital				
D	1. Determine that contributions, grants, and system development fees received during the period have been recorded as revenue.	_____	_____	_____
D	2. If depreciation on fixed assets is closed to the contributed capital equity account:			
	a. Determine whether the entity's accounting records have properly identified fixed assets recorded in the contributed capital equity account.	_____	_____	_____
	b. Review the computation of depreciation on such assets and reconcile total depreciation thereon to amounts charged to the contributed capital equity account.	_____	_____	_____
D	3. Analyze the propriety of other changes during the period in the contributed capital equity account.	_____	_____	_____
D E	4. Determine whether the entity has properly disclosed changes in the contributed capital equity account in its financial statements.	_____	_____	_____
G. Other Auditing Procedures—Reporting				
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 ¹ 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.	_____	_____	_____

¹ 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>
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.	_____	_____	_____

H. Overall Conclusions

1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:

- Proprietary fund revenue accounts include all transactions that relate to the period.
- Proprietary fund receivables are valid, complete, and stated at the net realizable amount.
- The costs associated with grant financed fixed assets are allowable and otherwise comply with program requirements.
- Contributed capital has been accounted for in accordance with GAAP.
- 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.

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.

.120

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)

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>
A. Evaluation of Internal Control				
	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. This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has determined 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.	_____	_____	_____
	3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	_____	_____	_____
B. Analytical Procedures				
	1. Review the planning procedures applicable to analytical procedures performed on 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 an analytical procedure is used as the principal substantive test of a significant financial statement assertion, document:			
	a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.	_____	_____	_____
	b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.	_____	_____	_____
	c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.	_____	_____	_____
C. Other Auditing Procedures—Risk Financing and Related Insurance Activities—General				
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 entity risk pool, and risk retention).	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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 policy 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.	_____	_____	_____
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 insurance 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 required payments have been made in accordance with the agreement and have been charged to the proper fund/function.	_____	_____	_____
D E	c. Obtain a copy of the financial statements from the public entity risk pool and determine whether the auditee 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). ¹	_____	_____	_____

¹ 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. Other Auditing Procedures—Risk Retention				
A	1. Determine whether the entity's risk retention programs comply with its policies.	_____	_____	_____
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.	_____	_____	_____
CDE	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:			
DE	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.	_____	_____	_____
CE	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:			

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
C D E	a. Determine whether premiums are:			
	(1) Recorded as charges for services in the internal service fund;	_____	_____	_____
	(2) Recorded as expenditures/expenses of the insured funds; and,	_____	_____	_____
	(3) Based on the loss experience (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.	_____	_____	_____
E. Overall Conclusions				
	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.	_____	_____	_____

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
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.

.130

Obj.Done
ByDateW/P
Ref.**XIII. Fiduciary Funds (Other Than Pension and Investment Trust Funds)¹****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)

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.

A. Evaluation of Internal Control

1. Review the understanding of internal control over fiduciary fund transactions and the preliminary assessment of control risk.

¹ 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. This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has determined 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.	_____	_____	_____
3.	Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	_____	_____	_____
B. Analytical Procedures				
1.	Review the planning procedures applicable to analytical procedures performed on fiduciary funds and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	_____	_____	_____
2.	If an analytical procedure is used as the principal substantive test of a significant financial statement assertion, document:			
a.	The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.	_____	_____	_____
b.	Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.	_____	_____	_____
c.	Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.	_____	_____	_____
C. Other Auditing Procedures—Agency Funds				
A	1. Determine the purpose of each agency fund.	_____	_____	_____
A	2. Trace collections into agency funds on a test basis.	_____	_____	_____
A	3. Trace disbursements from agency funds to supporting documentation on a test basis.	_____	_____	_____
A	4. Note and examine reports supporting payments to agency fund beneficiaries.	_____	_____	_____
A	5. Review presentation and note disclosure for conformity with GAAP.	_____	_____	_____
D. Other Auditing Procedures—Trust Funds (Other Than Pension and Investment Trust Funds)				
B	1. Obtain copies of documents establishing trust funds.	_____	_____	_____
B	2. Trace collections into trust funds on a test basis.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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 recognition presentation, and note disclosure for conformity with GAAP.	_____	_____	_____
E. Other Auditing Procedures—IRC Section 457 Deferred Compensation Plans				
C	1. If the entity has a deferred compensation plan that meets the criteria for reporting in the financial statements:			
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.	_____	_____	_____
F. Overall Conclusions				
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Agency funds have been properly established and maintained, and are reported in accordance with 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 _____				_____

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.

.135

Obj.Done
ByDateW/P
Ref.**XIIIB. Pension Trust Funds¹****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)

¹ 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>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.</p>			
A. Evaluation of Internal Control			
1. Review the understanding of internal control relative to pension trust funds and the preliminary assessment of control risk.	_____	_____	_____
2. For those assertions in which the auditor seeks a further reduction in the assessed level of control risk, perform tests of the effectiveness of the control activities in order to support the reduction in assessed level of control risk. This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has determined 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.	_____	_____	_____
3. Consider the understanding of internal control, the assessed level of control risk (together with assessment of inherent risk), and the acceptable level of detection risk to determine the nature, timing, and extent of substantive tests.	_____	_____	_____
B. Analytical Procedures			
1. Review the planning procedures applicable to analytical procedures performed on pension trust funds and consider the result of the procedures in determining the nature, timing, and extent of other audit procedures.	_____	_____	_____
2. If an analytical procedure is used as the principal substantive test of a significant financial statement assertion, document:			
a. The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development.	_____	_____	_____
b. Results of the comparison of the expectation to the recorded amounts or ratios developed from recorded amounts.	_____	_____	_____
c. Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures.	_____	_____	_____
C. Other Auditing Procedures—General			
[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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____
D. Other Auditing Procedures—Investments and Net Investment Income				
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.	_____	_____	_____
	a. Trace selected investment transactions to approval in minutes of governing board or other documentation of authorization.	_____	_____	_____
	b. 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.	_____	_____	_____
E. Other Auditing Procedures—Contributions and Related Receivables				
B	1. Obtain lists of participating employers, plan members, 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.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
B	4. Test a sample of items from the contribution reports to participant records and from participant records to contribution reports.	_____	_____	_____
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.	_____	_____	_____
F. Other Auditing Procedures—Benefit Payments and Payables				
C	1. Obtain a 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.	_____	_____	_____
G. Other Auditing Procedures—Other Financial Statement Elements and Disclosures				
E	1. Test the records of plan assets used in plan operations (for example, buildings, equipment, furniture and fixtures, software 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.	_____	_____	_____
H. Other Auditing Procedures—Participants' Data and Actuarial Valuations				
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 ²			
	(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.	_____	_____	_____

² See the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, 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.	_____	_____	_____
	I. Review Procedures—Required Supplementary Information³			
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.	_____	_____	_____
	J. Overall Conclusions			
	1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:			
	a. Investments reported in the financial statements are 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.	_____	_____	_____

³ These procedures reflect the limited procedures required by paragraph 7 of SAS No. 52, *Required Supplementary Information*, as amended (AU section 558.07). Different or additional procedures are required if the auditor's report will express an opinion whether the information is fairly presented in all material respects (a) in conformity with generally accepted accounting principles (GAAP) or (b) in relation to the financial statements taken as a whole (AU section 558.02 and .09).

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
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.

.140

Obj.Done
ByDateW/P
Ref.

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.

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.

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 audit documentation, 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 effects of misstatements, both individually and in the aggregate, 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. (A summary of uncorrected financial statement misstatements from step 2 should be included in or attached to the letter.) In addition to representations normally obtained in a GAAS audit (see SAS No. 85, <i>Management Representations</i> , as amended by SAS No. 89 [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. 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>
	j. Representations relative to GAAP-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 of the debt of other entities.	_____	_____	_____
	c. Long-term leases.	_____	_____	_____
	d. Projects with other entities (joint ventures) that require annual payments.	_____	_____	_____
	e. Commitments to purchase large quantities of materials or services.	_____	_____	_____
	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, including whether the results indicate a previously unrecognized risk of material misstatement due to fraud.	_____	_____	_____

B. Other Auditing Procedures—Review of Subsequent Events

Scope of Review

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. Others (list as applicable):			
	_____	_____	_____	_____
	_____	_____	_____	_____

C. Other Auditing Procedures—Report¹

C	1. Determine whether all required disclosures are included in the financial statements or notes. See <i>AICPA Checklists and Illustrative Financial Statements for State and Local Governmental Units</i> and any disclosure standards issued since the checklists were issued.	_____	_____	_____
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¹ 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 sections 12,200.150 and 12,350.

<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.	_____	_____	_____

D. Overall Conclusions

1. In our opinion, we have obtained sufficient and competent evidential matter to provide reasonable assurance that:
 - a. The financial statements being reported upon are fairly stated in accordance with 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.

.150

Obj.Done
ByDateW/P
Ref.

XV. Federal Financial Assistance (OMB Circular A-133 Single Audits)¹

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.

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.

A. Audit Planning

- E 1. Determine whether we have communicated with the entity's management (for example, through the engagement letter or

¹ 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, 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 Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, paragraphs 3.54 through 3.56, for a brief discussion of some of the considerations in auditing such grants.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____
	b. Determine whether the schedule:			
	(1) Includes all types of federal financial assistance as defined by OMB Circular A-133, paragraph .105.	_____	_____	_____

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	(2) Includes the minimum data elements required by OMB Circular A-133, paragraph .310(b), including notes that describe the significant accounting policies used. ²	_____	_____	_____
	(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. ³	_____	_____	_____
E	19. Compute planning materiality for each major program.	_____	_____	_____
[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 correspondence between the entity and the federal grantor and pass-through agencies applicable to major programs.	_____	_____	_____

² 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 the AICPA's Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*.

³ 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	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 <i>Government Auditing Standards</i> (GAS). If not, perform the following:			
	a. Determine that we are in conformity with the independence requirements of Government Auditing Standards Amendment 3, <i>Independence</i> , including its requirements concerning quality assurance, establishing an understanding with the audited entity, communication with management, and documentation. (Amendment 3, as affected by <i>Government Auditing Standards: Answers to Independence Questions</i> , is effective for audits for periods beginning on or after January 1, 2003.)	_____	_____	_____
	b. Determine whether we have communicated during the planning stage of the audit (for example, in the engagement letter) to appropriate officials of the entity (the head of the entity, the audit committee or board of directors, or the chief financial officer), third-parties contracting for or requesting the audit, and legislative members of staff of an oversight entity when law or regulation imposes an audit requirement on this particular entity:			
	(1) Our responsibilities in a financial statement audit, including our responsibility for testing and reporting on internal controls and compliance with laws and regulations, and whether we are planning on providing opinions on compliance with laws and regulations and internal control over financial reporting.	_____	_____	_____
	(2) The nature of any additional testing of internal controls and compliance required by laws and regulations.	_____	_____	_____
	(3) If this communication was made orally, determine whether the communication is included in the audit documentation.	_____	_____	_____
	c. Determine whether firm personnel assigned to the engagement have met the continuing education and training requirements and qualification standards of GAS.	_____	_____	_____
	d. Determine whether the firm has an appropriate internal quality control system and a current external quality control review.	_____	_____	_____
	e. 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.	_____	_____	_____
	f. Determine that the audit documentation includes the following for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems:			

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
(1) The basis for assessing control risk at the maximum level.	_____	_____	_____
(2) Consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level.	_____	_____	_____
g. 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.	_____	_____	_____
h. 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. ⁴	_____	_____	_____
B. Internal Control Over Compliance⁵			
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.	_____	_____	_____

⁴ 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. Paragraph 4.13 of *Government Auditing Standards* refers to additional responsibilities with regard to detecting material misstatements resulting from noncompliance with the provisions of contract and grant agreements that have a direct and material effect on the determination of financial statement amounts. However, it has generally been interpreted under GAAS that the phrase "laws and regulations" in SAS No. 54 implicitly includes the provisions of contracts and grant agreements. Thus, the auditor's responsibility with regard to detecting material misstatements resulting from noncompliance with the provisions of contracts and grant agreements under *Government Auditing Standards* equates to the auditor's responsibility under GAAS.

⁵ See the internal control objectives and characteristics of internal control over compliance with federal awards in AAM section 12,040.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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. ⁶	_____	_____	_____
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.	_____	_____	_____
	C. Compliance			
C	1. For each type of compliance requirement applicable to each major program:			
	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. ⁷	_____	_____	_____
	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. ⁸	_____	_____	_____

⁶ 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.

⁷ See footnote 4.

⁸ See footnote 4.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	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.	_____	_____	_____
D. Other Procedures				
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 audit documentation 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:			

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
	a. Retaining audit documentation 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 audit documentation 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.	_____	_____	_____
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. ⁹	_____	_____	_____
	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.	_____	_____	_____
	E. Reporting¹⁰			
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 .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.)	_____	_____	_____

⁹ 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.

¹⁰ 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 (Non-GASB 34 Edition)*.

<u>Obj.</u>		<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
E	7. Prepare a schedule of findings and questioned costs ¹¹ 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.	_____	_____	_____
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. Include any such oral communication in the audit documentation. 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. ¹²	_____	_____	_____
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.	_____	_____	_____

¹¹ See AAM section 12,200.180.

¹² The Federal Audit Clearinghouse permits online submissions of the data collection form on its Web site at <http://harvester.census.gov/sac> in a system called the Internet Data Entry System (IDES).

<u>Obj.</u>	<u>Done By</u>	<u>Date</u>	<u>W/P Ref.</u>
F. Overall Conclusions			
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.	_____	_____	_____
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 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: See AAM section 12,040 for an internal control checklist that allows you to obtain an understanding of internal control over the various compliance requirements for federal awards. OMB Circular A-133 requires that you plan the testing of internal control to support a low assessed level of control risk for each compliance requirement for each major program and perform the testing of internal control as planned. If internal control over a compliance requirement is likely to be ineffective, see the alternative procedures in section 500(c)(3) of OMB Circular A-133, which include assessing the control risk at the maximum and considering whether additional compliance tests and reporting are required because of ineffective internal control. You should consider the results of the testing of internal control in assessing the risk of noncompliance and as a basis for determining the nature, timing, and extent of substantive tests of compliance. Audit procedures for internal control and compliance testing may be accomplished using dual-purpose testing.

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 grants and subgrants to public institutions of higher education and governmental hospitals and 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 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.

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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The major source of requirements applicable to public institutions of higher education and governmental hospitals 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 and governmental hospitals that are subrecipients, regardless of the type of 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.

OMB budgetary guidance and Public Law 107-300 (the Improper Payments Information Act of 2002) require federal agencies to estimate improper payments made under federal awards. Improper payments are any payment that should not have been made or that was made in an incorrect amount (including overpayments and underpayments) under statutory, contractual, administrative, or other legally applicable requirements, including any payment to an ineligible recipient. Improper payments also are any payment for an ineligible service, any duplicate payment, payments for services not received, and any payments that does not account for credit for applicable discounts. The *Compliance Supplement* requires auditors to be alert to improper payments, particularly when testing: "A. Activities Allowed or Unallowed;" "B. Allowable Costs/Cost Principles;" "E. Eligibility;" and, in some cases, "N. Special Tests and Provisions."

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.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<i>Audit Procedures</i>			
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 except public institutions of higher education and governmental hospitals (referred to in this section as 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*. However, state rules for expenditures of state funds apply for block grants authorized by the Omnibus Budget Reconciliation Act of 1981 and the Job Training Partnership Act.

Public institutions of higher education are subject to the cost principles of OMB Circular A-21, *Cost Principles for Educational Institutions*, which incorporates the four Cost Accounting Standards Board (CASB) Standards and the Disclosure Statement (DS-2) requirements.

Federal awards administered by governmental 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 applicable to a non-federal entity 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. The circulars describe selected cost items, allowable and unallowable costs, and standard methodologies for calculating indirect costs rates. The cost principles in the two cost principles circulars are in most cases substantially identical but a few differences do exist. Part 3 of the *Compliance Supplement* contains an exhibit that lists the treatment of the selected costs items by the circulars.

Compliance Requirements—Allowability of Costs—General Criteria (Applicable to Both Direct and Indirect Costs)

- Costs must be reasonable and necessary for the performance and administration of federal awards.

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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- Costs must be allocable to the federal awards under the provisions of the cost principles or CASB Standards, as applicable. 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 for public institutions of higher education or the A-102 Common Rule for state, local, and Indian tribal governments.

State, Local, and Indian Tribal Governments

Compliance Requirements—Indirect Costs

Note: See Part 3 of the *Compliance Supplement* for a discussion of the different types of indirect cost rates and the different types of cost allocation plans (CAPs) and indirect cost rate proposals (IDCRPs). Additional information on cost allocation plans and indirect cost rates is found in the Department of Health and Human Services (HHS) publications: *A Guide for State, Local and Indian Tribal Governments* (ASMB C-10); and the *Review Guide for States and Local Governments State/Local-Wide Central Service Cost Allocation Plans and Indirect Cost Rates*, which are available on the Internet at <http://rates.psc.gov>.

- These costs are subject to negotiated indirect cost rate agreements or award-specific indirect cost rates.
- States, major local governments and Indian tribal governments must prepare CAPs or IDCRPs and submit the plan to the cognizant agency for cost negotiation and approval.
- Other organizations, such as smaller local governments, must prepare the appropriate CAPs or IDCRPs, and maintain the plan on file for review.
- Concerning the billed central services costs (section II costs) in state/local-wide central service CAPs:
 1. Billed central services must be adjusted using one of four allowable methods when there is a difference between the revenue generated by each billed service and the actual allowable costs.

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2. Whenever funds are transferred from a self-insurance reserve to other accounts (such as the general fund), refunds must be made to the federal government for its share of funds transferred, including earned or imputed interest from the date of transfer.
- Concerning public assistance CAPs (PACAPs), auditors should verify that the entity complies with the approved cost allocation plan.

Audit Objectives (Both Direct and Indirect Costs)—Determine whether the organization complied with the provisions of OMB Circular A-87 as follows:

- Direct charges to federal awards were for allowable costs.
- Charges to cost pools used in calculating indirect cost rates were for allowable costs.
- Charges to cost pools allocated to federal awards through CAPs were for allowable costs.
- 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 benefitting cost objectives).
- Indirect cost rates were applied in accordance with approved rate agreements, or special award provisions or limitations, if different from those stated in negotiated rate agreements. Associated billings were the result of applying the appropriate rate to the proper base amount(s).
- Other organizations, such as smaller local governments, must prepare the appropriate CAPs or IDCPRs, and maintain the plan on file for review.

Note: The following procedures apply to direct charges to federal awards as well as to charges to cost pools that are allocated wholly or partially to federal awards or used in formulating indirect cost rates used for recovering indirect costs from federal awards. If the auditor identifies unallowable costs, the auditor should be aware that “directly associated costs” may have been charged. *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. When an unallowable cost is incurred, directly associated costs are also unallowable.

1. Test a sample of transactions to determine that the costs:
 - a. Are authorized or not prohibited under state or local laws or regulations.

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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. With respect to fringe benefit allocations, charges, or rates, such allocations, charges, or rates 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. (Note that consistency in accounting requires that costs incurred for the same purpose, in like circumstances, be treated as either direct costs only or indirect costs only with respect to final cost objectives.)	_____	_____	_____
i. Are calculated in conformity with generally accepted accounting principles, or another comprehensive basis of accounting, when 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 IDCRCs if 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. (Note that documentation requirements for salaries and wages, and time and effort distribution are described in applicable cost principles.)	_____	_____	_____
2. When material charges are made from internal service, central service, pension, or similar activities or funds, verify that the charges from these 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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
(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.	_____	_____	_____
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 which is not over two years old.	_____	_____	_____

Note: An IDCRC is based upon costs that often precede the year in which the IDCRC is prepared and the resulting Indirect Cost Rate Agreement (IDCRA) is used to charge indirect costs. There is a timing consideration in that the audit (which covers the applicable cost pools) may be completed before the IDCRC is submitted. When the IDCRA is the basis for material charges to a major program, the auditor is required to obtain appropriate assurance that the costs collected in the cost pools and allocation methods are in compliance with the applicable cost principles. Part 3 of the *Compliance Supplement* describes acceptable options the auditor may use to obtain that assurance. The costs allocated through CAPs (including PACAPs) may include current year and prior year costs, therefore, the auditor should test the costs charged to cost pools in the supporting CAPs and the methods of allocating costs from CAPs in each year when those costs are material to a major program.

3. For IDCRCs and CAPs:

- | | | | |
|--|-------|-------|-------|
| a. Test the cost pools that form the basis of the IDCRC and CAP and the resulting charges to federal awards to determine whether they include only allowable costs in accordance with the applicable cost principles. (See audit procedure 1 above.) | _____ | _____ | _____ |
| b. Test the methods of allocating the costs to determine whether they are in accordance with the applicable 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 | | | |

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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. (For PACAPs, because the most significant cost pools in terms of dollars, are usually allocated based upon the distribution of income maintenance and social services workers efforts identified through time studies, determine whether the time studies are implemented and operated in accordance with the methodologies described in the approved CAP. Review the adequacy of the controls governing the conduct and evaluation of the study, determine that the sample observations were properly selected and performed, the documentation of the observations were properly completed, and that the results of the study were correctly accumulated and applied.	_____	_____	_____
(3) Review the allocation methodology for consistency and test the appropriateness of methods used to make changes.	_____	_____	_____
4. For IDCRA's and CAPs:			
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 <i>b</i> through <i>e</i> 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 verify that the rates used are in accordance with the rate agreement, that rates were applied to the appropriate bases, and that the amounts claimed were the product of applying the rate to the applicable base. Verify that the costs included in the base(s) are consistent with the costs that were included in the base year (such as 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 PACAPs, verify that the methods of charging costs to federal awards are in accordance with the approved PACAP and the provisions of the approval documents issued by the cognizant federal agency.	_____	_____	_____
e. For state/local-wide central service CAPs, determine whether the amounts used for reimbursement of central service costs for federal awards were in accordance with the approved CAPs or plans on file, when approval is not required.	_____	_____	_____

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Public Institutions of Higher Education

Compliance Requirements—Indirect Costs

Note: At colleges and universities, indirect costs are accounted for through Facilities & Administration Proposals (F&A). F&A costs, for the purpose of OMB Circular A-21, means costs that are incurred for common or joint objectives and, therefore, cannot be identified readily and specifically with a particular sponsored project, an instructional activity, or any other institutional activity. As described in OMB Circular A-21, section F.1, the F&A cost categories include: building and equipment depreciation or use allowance; operation and maintenance expenses; interest expenses; general administrative expenses; departmental administration expenses; library expenses; and student administration expenses.

Additional information on indirect cost rates is found in the Department of Health and Human Services (HHS) publication: *Review Guide for Long-Form University Facilities & Administrative Cost Proposals*, which is available on the Internet at <http://rates.psc.gov>.

- Institutions must prepare IDCRCs in accordance with the guidelines provided in OMB Circular A-21 and submit the IDCRC to the cognizant agency for indirect cost negotiation for approval.
- The IDCRC must be based on the most current financial data supported by the organization's accounting system and audited financial statements.

Compliance Requirements—Disclosure Statements

- If an institution receives more than \$25 million in federal funding in a fiscal year, it should prepare and submit a Disclosure Statement (DS-2) that describes the institution's cost accounting practices, maintain an accurate DS-2, and comply with disclosed cost accounting practices. It also should file amendments to the DS-2 when it modifies disclosed practices.

Compliance Requirements—Large Research Facilities Construction Costs

- For large research facilities (those with construction costs of more than \$10 million) of which 40 percent or more of total assignable space is expected for federal use, the institution must maintain an adequate review and approval process to ensure that construction costs are reasonable. The review process shall address and document relevant factors affecting construction costs. The approval process must include review and approval of the projects by the institution's Board of Trustees or other independent entities.
- For research facilities costing more than \$25 million, of which 50 percent or more of total assignable space is expected for federal use, the institution must document the review steps performed to assure that construction costs are reasonable. The review should include an analysis of construction costs and a comparison of these costs with relevant construction data.

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Compliance Requirements—Standard Format for Long Form Proposals

- For F&A rate proposals submitted on or after July 1, 2001, institutions must use the standard format shown in OMB Circular A-21, Appendix C, to submit their F&A rate proposal to the cognizant agency for indirect costs. The cognizant agency for indirect costs may, on an institution-by-institution basis, grant exceptions from all or portions of Part II of the standard format. This requirement does not apply to institutions of higher education that use the simplified method for calculating F&A rates, as described in OMB Circular A-21, section H.

Audit Objectives (Both Direct and Indirect Costs)—Determine whether the organization complied with the provisions of OMB Circular A-21 and CASB Standards as follows:

- Direct charges to federal awards were for allowable costs.
- Charges to cost pools used in calculating indirect cost rates were for allowable costs.
- The methods of allocating the costs are in accordance with the applicable cost principles or CASB Standards 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 benefitting cost objectives).
- Indirect cost rates were applied in accordance with approved rate agreements, or special award provisions or limitations, if different from those stated in negotiated rate agreements. Associated billings were the result of applying the approved rate to the proper base amount.
- Cost accounting practice disclosures, described in the DS-2 (including amendments), if applicable, represented actual practice consistently applied.
- The institution's review of large research facilities under construction was documented as required.

Audit Procedures (Both Direct and Indirect Costs)

Note: The following procedures apply to direct charges to federal awards as well as to charges to cost pools that are allocated wholly or partially to federal awards or used in formulating indirect cost rates used for recovering indirect costs from federal awards. If the auditor identifies unallowable costs, the auditor should be aware that "directly associated costs" may have been charged. *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. When an unallowable cost is incurred, directly associated costs are also unallowable.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
1. Test a sample of transactions to determine that the costs:			
a. Are approved by the federal awarding agency, if required.	_____	_____	_____
b. Conform with the allowability of costs provisions of applicable cost principles, or limitations in the program agreement, program regulations, or program statute.	_____	_____	_____
c. Conform with the allocability provisions of applicable cost principles or CASB Standards.	_____	_____	_____
d. Represent charges for actual costs, not budgeted or projected amounts.	_____	_____	_____
e. With respect to fringe benefit allocations, charges, or rates, such allocations, charges, or rates are based on the benefits received by different classes of employees within the organization.	_____	_____	_____
f. Are applied uniformly to federal and non-federal activities.	_____	_____	_____
g. Are given consistent accounting treatment within and between accounting periods. (Note that consistency in accounting requires that costs incurred for the same purpose, in like circumstances, be treated as either direct costs only or indirect costs only with respect to final cost objectives.)	_____	_____	_____
h. Are calculated in conformity with CASB Standards, generally accepted accounting principles, or another comprehensive basis of accounting, when required under the applicable cost principles or CASB Standards. (Note that costs for post-employment benefits must be funded to be allowable.)	_____	_____	_____
i. 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.	_____	_____	_____
j. Are net of all applicable credits.	_____	_____	_____
k. 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 IDCSPs, if charged directly to federal awards).	_____	_____	_____
l. 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. (Note that documentation requirements for salaries and wages, and time and effort distribution are described in applicable cost principles.)	_____	_____	_____
2. When material charges are made from internal service, central service, pension, or similar activities or funds, verify that the charges from these 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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
(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.	_____	_____	_____
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 which is not over two years old.	_____	_____	_____
<p>Note: An IDCRC is based upon costs charged to cost pools representing costs of a base year that often precedes the year in which the IDCRC is prepared and the year the resulting Indirect Cost Rate Agreement (IDCRA) is used to charge indirect costs. (A detailed example is provided in Part 3 of the <i>Compliance Supplement</i>.) An audit timing consideration is that the audit for the base year (which covers the applicable cost pools) may be completed before the IDCRC is submitted. When the IDCRA is the basis for material charges to a major program, the auditor is required to obtain appropriate assurance that the costs collected in the cost pools and allocation methods are in compliance with the applicable cost principles. Part 3 of the <i>Compliance Supplement</i> describes acceptable options the auditor may use to obtain that assurance.</p>			
3. When material charges are made to a major program based upon an IDCRC, determine whether the IDCRC was tested in a prior year.	_____	_____	_____
a. When the testing performed in a prior year provides appropriate audit assurance, further review of the IDCRC is not required unless there have been material changes to cost accounting practices supporting the IDCRC. To determine whether there have been material changes, inquire of auditee management as to 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 auditee is required to file the IDCRC with a cognizant agency for indirect cost negotiation, determine whether the entity notified the federal cognizant agency for indirect cost	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
negotiation of the changes in cost accounting practices. (For non-federal entities that are required to file a DS-2, this testing is performed in audit procedure 5 below.)	_____	_____	_____
4. If prior testing of the IDCRCR does not provide appropriate audit assurance (for example, of testing was not performed):			
a. Test the cost pools that form the basis of the IDCRCR and the resulting charges to federal awards to determine whether they include only allowable costs in accordance with the cost principles or CASB Standards, as applicable. (See audit procedure 1 above.)	_____	_____	_____
b. Test the methods of allocating the costs to determine whether they are in accordance with the provisions of the cost principles or CASB Standards, as applicable, 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.	_____	_____	_____
(3) Review the allocation methodology for consistency and test the appropriateness of methods used to make changes.	_____	_____	_____
5. For IDCRA's:			
a. Determine whether material indirect costs or centralized or administrative services costs were allocated or charged to a major program. If not, the following suggested audit procedures <i>b</i> and <i>c</i> do not apply.	_____	_____	_____
b. Obtain and read the current IDCRA and determine the terms in effect.	_____	_____	_____
c. Select a sample of claims for reimbursement and verify that the rates used are in accordance with the rate agreement, that rates were applied to the appropriate bases, and that the amounts claimed were the product of applying the rate to the applicable base. Verify that the costs included in the base(s) are consistent with the costs that were included in the base year (such as 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).	_____	_____	_____
6. Perform the following procedures for DS-2, as applicable:			
a. Read the DS-2 and its amendments and determine whether the disclosures agree with the policies prescribed in the institution's policies and procedures documents.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
b. Test that the disclosures agree with actual practices for the period covered by audit, including whether the practices were consistent throughout the period.	_____	_____	_____
7. Perform the following procedures related to large research facilities:			
a. Determine whether the institution had large research facilities as defined in OMB Circular A-21 under construction. If not, the following suggested audit procedures <i>b</i> and <i>c</i> do not apply.	_____	_____	_____
b. For large research facilities under construction of which 40 percent or more of total assignable space is expected for federal use, review the institution's approval process that should include board minutes or other documentation to determine whether the institution's Board of Trustees or other independent entity reviewed and approved these construction projects.	_____	_____	_____
c. For research facilities under construction costing more than \$25 million of which 50 percent or more of total assignable space is expected for federal use, determine whether the institution documented the review steps performed to assure that construction costs are reasonable.	_____	_____	_____

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.
- 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.
- 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.
- 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.

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- 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 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. The U.S. Treasury, Financial Management Service, maintains a Cash Management Improvement Act page on the Internet (www.fms.treas.gov/cmia/).
- 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.

Audit Objectives

- Entities that are not states followed procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury, or pass-through entity, and their disbursement.
- Entities that are states complied with the terms and conditions of the Treasury-State agreement or default procedures prescribed by Treasury.
- The pass-through entity implemented procedures to assure that subrecipients conformed substantially to the same timing requirements that apply to the pass-through entity.
- Interest earned on advances was reported/remitted as required.

Audit Procedures

The following procedures are intended to be applied to each major program. However, due to the nature of cash management and the system of cash management in place in a particular entity, it may be appropriate and more efficient to perform these procedures for all programs collectively rather than separately for each program.

For States

1. Verify which of the state's major programs are covered by the Treasury-State agreement in accordance with the materiality thresholds in Appendix A to subpart A of 31 CFR part 205 (31 CFR section 205.4).
2. For those programs identified in audit procedure 1, determine the funding techniques used for those programs. For those funding techniques that require clearance patterns to schedule the transfer of funds to the state, review documentation supporting the clearance pattern and verify that the clearance pattern conforms to the requirements for developing and maintaining clearance patterns as specified in the Treasury-State agreement (31 CFR sections 205.8 and 205.9(b)(4)).

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
3. Select a sample of federal cash draws and verify that:			
a. The timing of the federal cash draws were in compliance with the applicable funding techniques specified in the Treasury-State agreement or Subpart B procedures, whichever is applicable (31 CFR sections 205.7 and 205.20).	_____	_____	_____
b. To the extent available, program income, rebates, refunds, and other income and receipts were disbursed before requesting additional federal cash draws as required by the A-102 Common Rule (§.21) and OMB Circular A-110 (§.22).	_____	_____	_____
4. 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 (31 CFR section 205.7(c)(5)).	_____	_____	_____
5. 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 Subpart B procedures. Trace amounts used in the calculation to supporting documentation.	_____	_____	_____
<i>For States and Other Recipients</i>			
6. For those programs where federal cash draws are passed through to subrecipients:			
a. Select a representative sample of subrecipients and determine the procedures implemented to assure that subrecipients minimize the time elapsing between the transfer of federal funds from the recipient and the pay out of funds for program purposes (A-102 Common Rule §.37(a)(4)).	_____	_____	_____
b. Select a representative sample of federal cash draws by subrecipients and determine whether they conformed to the procedures.	_____	_____	_____
<i>For Other Recipients and Subrecipients</i>			
7. For those programs that received advances of federal funds, determine the procedures established with the federal agency or pass-through entity to minimize the time between the transfer of federal funds and the pay out of funds for program purposes.	_____	_____	_____
8. Select a sample of federal cash draws and verify that:			
a. Established procedures to minimize the time elapsing between drawdown and disbursement were followed.	_____	_____	_____
b. To the extent available, program income, rebates, refunds, and other income and receipts were disbursed before requesting additional cash payments as required by the A-102 Common Rule (§.21) and OMB Circular A-110 (§.22).	_____	_____	_____
9. 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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
10. Review records to determine if interest was earned on federal cash draws. If so, review evidence to determine whether it was returned to the appropriate agency.	_____	_____	_____
D. Davis-Bacon Act			
<p><i>Compliance Requirements</i>—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. This includes a requirement for the contractor or subcontractor to submit to the non-Federal entity weekly, for each week in which any contract work is performed, a copy of the payroll and a statement of compliance (certified payrolls). This reporting is often done using Optional Form WH-347 which includes the required statement of compliance. The U.S. Department of Labor, Employment Standards Administration, maintains a Davis-Bacon and Related Acts Internet page at www.dol.gov/dol/esa/public/programs/dbra/index.html. Optional Form WH-347 and instructions are available on that Internet page.</p> <p><i>Audit Objective</i>—Determine whether the entity notified contractors and subcontractors of the requirements to comply with the Davis-Bacon Act and obtained copies of certified payrolls.</p> <p><i>Audit Procedures</i></p> <ol style="list-style-type: none"> 1. Select a sample of construction contracts and subcontracts greater than \$2,000 that are covered by the Davis-Bacon Act and: <ol style="list-style-type: none"> a. Verify that the required prevailing wage rate clauses were included. b. Verify that the contractor or subcontractor submitted weekly the required certified payrolls. 			
E. Eligibility			
<p><i>Compliance Requirements</i>—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.</p> <p><i>Audit Objectives</i></p> <ul style="list-style-type: none"> • 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. 			

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<ul style="list-style-type: none"> • Determine whether amounts provided to or on behalf of eligibles were calculated in accordance with program requirements. • Determine whether amounts provided to or on behalf of eligibles were calculated in accordance with program requirements. 			
<i>Audit Procedures</i> ^{1,2}			
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.	_____	_____	_____
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.	_____	_____	_____

¹ 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. In addition, the auditor should consider the requirements of *Government Auditing Standards, Amendment No. 1, Documentation Requirements When Assessing Control Risk at Maximum for Controls Significantly Dependent Upon Computerized Information Systems*.

² Some non-federal entities pay the federal benefits to the eligible participants but arrange with another entity to perform part or all of the eligibility determination. For example, a state arranges with local government social services agencies to perform the "intake function" (that is, the meeting with the social services client to determine income and categorical eligibility) while the state maintains the computer systems supporting the eligibility determination process and actually pays the benefits to the participants. The state is fully responsible for federal compliance for the eligibility determination. Therefore, the state's auditor is responsible for meeting the audit objectives for eligibility. This may require the state's auditor to perform or arrange for additional procedures to ensure compliant eligibility determinations when another entity performs part of the eligibility determination functions. The state's auditor should ensure that eligibility testing includes all benefit payments regardless of whether another entity, by arrangement, performs part of the eligibility determination functions.

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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. Equipment³ and Real Property Management

Compliance Requirements

Equipment is 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 \$5000 or more per unit. However, a non-federal entity may establish a lower limit, consistent with its own policy.

- 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 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.

³ 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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- 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, as defined in the *Compliance Supplement*. 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.
- 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.

Audit Procedures

(Procedure 1 only applies to subrecipients of states that are local governments or Indian tribal governments. Procedure 2 only applies to states and to subrecipients of states that are local governments or Indian tribal governments.)

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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, governmental hospitals 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.	_____	_____	_____
<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.

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
_____	_____	_____

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.
- 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.

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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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. | _____ | _____ | _____ |
| 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. | _____ | _____ | _____ |

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
(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.	_____	_____	_____
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.	_____	_____	_____

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. 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.

<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 state 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 and governmental hospitals are to use procurement procedures that conform to applicable federal law and regulations and standards identified in OMB Circular A-110.

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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- All 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

- 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 non-procurement 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.
- Requirements for suspension and debarment are contained in the federal agencies' codification of the government-wide debarment and suspension common rule (see Appendix II of the *Compliance Supplement* for CFR cites), which implements Executive Orders 12549 and 12689, Debarment and Suspension, and the terms of the award.

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, governmental hospitals, 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:

_____	_____	_____
_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
<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 non-federal funds.	_____	_____	_____
<i>(Procedures 6 applies to all 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.	_____	_____	_____

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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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 and governmental hospitals, 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 (sections .21 (payment) and .25), OMB Circular A-110 (sections .2 (program income definition), .22 (payment), and .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.

_____	_____	_____
_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
3. Perform tests to verify that program income was properly determined or calculated in accordance with stated criteria, and that program income was only collected from allowable sources.	_____	_____	_____
4. Perform tests to verify that all program income was properly recorded in the accounting records.	_____	_____	_____
5. 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.	_____	_____	_____

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.

Audit Objective—Determine whether the entity complied with the real property acquisition, appraisal, negotiation, and relocation requirements.

Audit Procedures

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|---|---|-------|-------|-------|-------|-------|-------|
| <ol style="list-style-type: none"> 1. Inquire of management and review the records of federal programs to determine whether the 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: <ol style="list-style-type: none"> 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. | <table border="0"> <tr> <td>_____</td> <td>_____</td> <td>_____</td> </tr> <tr> <td>_____</td> <td>_____</td> <td>_____</td> </tr> </table> | _____ | _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | | | | | |
| _____ | _____ | _____ | | | | | |

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
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.

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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L. Reporting

Compliance Requirements

Note: See also Parts 4 and 5 of the *Compliance Supplement* for programs listed therein.

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 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.

<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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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.

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:

_____	_____	_____
_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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.	_____	_____	_____
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.	_____	_____	_____

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
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:

- *Award Identification*—At the time of the award, identifying to the subrecipient the federal award information (such as CFDA title and number, award name, name of Federal agency) and applicable compliance requirements
- *During-the-Award Monitoring*—Monitoring the subrecipient's use of federal awards through site visits or other means to provide reasonable assurance that the subrecipient administers federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved
- *Subrecipient Audits*—Ensuring required audits are completed within nine months of the end of the subrecipient's audit period, issuing a management decision on audit findings within six months after receipt of the subrecipient's audit report, and ensuring that the subrecipient takes timely and appropriate corrective action on all audit findings (In cases of continued inability or unwillingness of a subrecipient to have the required audits, the pass-through entity is required to take appropriate action using sanctions.)
- *Pass-Through Entity Impact*—Evaluating the impact of subrecipient activities on the pass-through entity's ability to comply with applicable federal regulations

Note: Part 3 of the *Compliance Supplement* describes example factors that may affect the nature, timing, and extent of during-the-award monitoring as well as various forms of monitoring activities. It also describes when the costs of agreed-upon procedures engagements to monitor certain aspects of subrecipient activities are allowable costs to the pass-through entity. The requirements for subrecipient monitoring are contained in the 31 USC 7502(f)(2)(B) (Single Audit Act Amendments of 1996 [P. L. 104-156]), OMB Circular A-133 (sections .225 and .400(d)), A-102 Common Rule (sections .37 and .40(a)), and OMB Circular A-110 (section .51(a)), federal awarding agency program regulations, and the terms and conditions of the award.

Audit Objectives—Determine whether the pass-through entity:

- Properly identified federal award information and compliance requirements to the subrecipient, and approved only allowable activities in the award documents

	<u>Done by</u>	<u>Date</u>	<u>W/P Ref.</u>
<ul style="list-style-type: none">• Monitored subrecipient activities to provide reasonable assurance that the subrecipient administers federal awards in compliance with federal requirements• Ensures required audits are performed, issued a management decision on audit findings within six months after receipt of the subrecipient’s audit report, and ensures that the subrecipient takes timely and appropriate corrective action on all audit findings• Took appropriate action using sanctions in cases of continued inability or unwillingness of a subrecipient to have the required audits• Evaluates the impact of subrecipient activities on the pass-through entity			

Audit Procedures

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.)

1. Gain an understanding of the pass-through entity’s subrecipient procedures through a review of its subrecipient monitoring policies and procedures (such as its annual monitoring plan) and discussions with staff. This should include an understanding of the scope, frequency, and timeliness of monitoring activities and the number, size, and complexity of awards to subrecipients.	_____	_____	_____
2. Test award documents and agreements to determine whether (a) at the time of award the pass-through entity made subrecipients aware of the award information (such as CFDA title and number, amount of award, award name, name of federal agency) and requirements imposed by laws, regulations, and the provisions of contract or grant agreements; and (b) the activities approved in the award documents were allowable.	_____	_____	_____
3. Review the pass-through entity’s documentation of during-the-award monitoring to determine whether its monitoring provided reasonable assurance that subrecipients used federal awards for authorized purposes, complied with laws, regulations, and the provisions of contracts and grant agreements, and achieved performance goals.	_____	_____	_____
4. Review the pass-through entity’s follow-up to ensure corrective action on deficiencies noted in during-the-award monitoring.	_____	_____	_____
5. Verify that the pass-through entity receives audit reports from subrecipients required to have an audit in accordance with OMB Circular A-133, issues management decisions on audit findings			

	<i><u>Done by</u></i>	<i><u>Date</u></i>	<i><u>W/P Ref.</u></i>
within six months after receipt of the subrecipient's audit report, and ensures that subrecipients takes appropriate and timely corrective action on all audit findings.	_____	_____	_____
6. Verify that in cases of continued inability or unwillingness of a subrecipient to have the required audits, the pass-through entity took appropriate action using sanctions.	_____	_____	_____
7. Verify that the effects of subrecipient noncompliance are properly reflected in the pass-through entity's records.	_____	_____	_____
8. Verify that the pass-through entity monitored the activities of subrecipients not subject to OMB Circular A-133, using techniques such as those discussed earlier in this section (with the exception that these subrecipients are not required to have audits under OMB Circular A-133).	_____	_____	_____

.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. See also Appendix A to chapter 3 of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, which describes the requirements of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU section 316), and discusses government-specific considerations. Auditors also may wish to refer to the AICPA Practice Aid entitled *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide*, which explains the provisions of SAS No. 99 (AU section 316) and provides detailed implementation guidance. The Practice Aid also includes appendixes to help identify risks of material misstatement due to fraud in specialized industries, including state and local government.

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 tax assessments.
 - 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 and information technology 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 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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[The next page is 12,371.]

AAM Section 12,210

Suggested Supplemental Reference Materials for Use With Illustrative Audit Programs for State and Local Governmental Units

.01 The annual AICPA Audit Risk Alert, *State and Local Governmental Developments*, includes references for governmental accounting and auditing guidance, including web site addresses and order department telephone numbers. Additional information is shown below.

American Institute of Certified Public Accountants (AICPA)

Audit Guide—*Audit Sampling*

Audit Guide—*Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

Audit Guide—*Consideration of Internal Control in a Financial Statement Audit*

Audit Guide—*Service Organizations: Applying SAS No. 70, as Amended*

Audit and Accounting Guide—*Audits of Employee Benefit Plans*

Audit and Accounting Guide—*Audits of Property and Liability Insurance Companies*

Audit and Accounting Guide—*Health Care Organizations*

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.

AICPA Code of Professional Conduct, Ethics Section 92.01, definition of *client* (reissued in 1998) (included in *Professional Standards*)

Ethics Interpretation No. 101-10—“The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements” (reissued in 2003) (included in *Professional Standards*)

Ethics Interpretation No. 501-3—“Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits” (included in *Professional Standards*)

Statement on Auditing Standards No. 74—*Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (included in *Professional Standards*)

Securities and Exchange Commission

SEC Rule 15c2-12, relating to primary offerings of municipal securities (17 Code of Federal Regulations §240.15c2-12)

SEC Interpretive Release No. 33-7049 and No. 34-33741, *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*

SEC Interpretation Release No. 33-7856 and No. 34-42728, *Use of Electronic Media*

Other

Single Audit Act Amendments of 1996 (Public Law 104-156) and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Appendixes A and B, respectively, of AICPA Statement of Position 98-3, *Audits of State, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*)

Data Collection Form for Reporting on Audits of States, Local Governments, and Non-Profit Organizations (Form SF-FAC)—printed copy from Federal Audit Clearinghouse (FAC) at (888) 222-9907; electronic copy at <http://www.whitehouse.gov/OMB/grants>; electronic submissions at FAC Web site at <http://harvester.census.gov/sac>.

Applicable State Laws and Administrative Rules and Regulations

Local Government Charter

Local Laws, Rules, and Regulations

[The next page is 12,381.]

AAM Section 12,300

Partner's Engagement Review Program Supplement for Governmental Units¹

To be completed in conjunction with Partner's Engagement Review Program [AAM section 9210]

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
I. General Audit Procedures			
A. .010 General			
1. In planning the audit engagement, were the following matters properly considered:			
a. Matters affecting the government, such as specialized accounting practices, economic conditions, federal and state laws and regulations, and technological changes?	_____	_____	_____
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? This includes situations in which significant audit evidence is transmitted, processed, maintained, or accessed electronically, and the auditor has determined 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.	_____	_____	_____
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?	_____	_____	_____
6. Did you (the engagement partner) participate in discussions among engagement personnel regarding the risks of material misstatement	_____	_____	_____

¹ The Governmental Accounting Standards Board (GASB) has issued several pronouncements that will make significant changes in how most state and local governmental entities account for and report on their transactions and balances in the future. In addition, the AICPA Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)* addresses the audits of financial statements prepared in conformity with those GASB pronouncements. This program does not incorporate the changes that might be needed as a result of those GASB pronouncements or that Guide. See the discussion of those GASB pronouncements, that Guide, and the planned AICPA Practice Aid in the headnote in AAM section 12,000. Those changes will be incorporated into this form in the future.

due to fraud as well as ascertain that there was appropriate communication about the risks of material misstatement due to fraud among team members throughout the audit.

Yes No N/A

II. Audit Documentation Areas

A. .020 Budgetary Compliance and Reporting

1. Were appropriate procedures performed on the entity's budgetary compliance and reporting?

B. .030 Cash

1. Does the audit documentation indicate that the following were considered:

- a.* Verification of collateral required of depository institutions for public funds?

- 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?

C. .040 Investments and Investment Income

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?

D. .050 Receivables, Including Interfund Receivables

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?

E. .060 Inventories and Prepaid Items

1. Does the audit documentation indicate that appropriate procedures were performed to test the entity's accounting and financial reporting for inventories and prepaid items?

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
F. .070 Fixed Assets			
1. Was a review made to determine whether fixed assets are classified in the proper fund or account group and properly stated as to amount, including accumulated depreciation (if applicable)?	_____	_____	_____
G. .080 Liabilities, Including Interfund Liabilities			
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?	_____	_____	_____
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?	_____	_____	_____
H. .090 Deferred Revenue			
1. Does the audit documentation 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?	_____	_____	_____
I. .100 Commitments and Contingencies			
1. Does the audit documentation include indication of 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?	_____	_____	_____
2. Have all material contingencies been properly considered, documented, and reported?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
J. .110 Fund Equity			
1. Were authorizations of changes in reserves and designated balances examined?	_____	_____	_____
2. Does the audit documentation indicate that there were inquiries, where appropriate, as to proper classification, description, and disclosures of components of fund equity?	_____	_____	_____
K. .120 Revenues and Expenditures/Expenses, Including Interfund Transactions			
1. Were revenues and expenditures and/or expenses for the period compared with those of the preceding period and reviewed for reasonableness and were significant fluctuations explained?	_____	_____	_____
2. Was adequate consideration given to the entity's revenue and expenditure recognition policies?	_____	_____	_____
3. Does the audit documentation indicate that revenues and expenditures/expenses have been recognized in conformity 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. Does the audit documentation 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?	_____	_____	_____
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	<u>Yes</u>	<u>No</u>	<u>N/A</u>
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> ?	_____	_____	_____
5. Was appropriate consideration given to the single audit guidance contained in AICPA Audit Guide <i>Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards</i> ?	_____	_____	_____
6. Did we appropriately identify major programs?	_____	_____	_____
7. 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 8 below)?	_____	_____	_____
8. 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?	_____	_____	_____
9. Were all reportable conditions in internal control disclosed in the auditor's reports?	_____	_____	_____
10. 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?	_____	_____	_____
11. If warranted, did we communicate with the cognizant agency to avoid or minimize any disagreements or problems?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
12. Did the financial statement audit comply with the additional requirements of <i>Government Auditing Standards</i> ? ²	_____	_____	_____
13. 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 12,391.]

² See AAM section 12,350, *Government Auditing Standards Requirements*.

AAM Section 12,350

Government Auditing Standards *Requirements*¹

Overview

.01 This section discusses the financial statement audit requirements² of the 1994 revision to the *Government Auditing Standards*, as amended through *Government Auditing Standards Amendment 3*, "Independence," that go beyond the requirements of an audit in accordance with generally accepted auditing standards (GAAS). *Government Auditing Standards*, issued by the Comptroller General of the United States, often called the Yellow Book or generally accepted government auditing standards (GAGAS), are to be followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy. While *Government Auditing Standards* are an integral part of an audit of federal awards under the provisions of Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, they also may be required in other situations. For example, a state government that provides state grants to local governments may require audits in accordance with *Government Auditing Standards* as part of the grant contract. Therefore, this section may be helpful to auditors who are conducting an audit in accordance with *Government Auditing Standards*, but not under the provisions of OMB Circular A-133. The auditor should consider using this section in conjunction with *Government Auditing Standards* and its three amendments, which are available from the U.S. General Accounting Office (GAO) Web site at www.gao.gov/govaud/ybk01.htm.³

.02 *Government Auditing Standards* incorporates all AICPA audit standards for field work and reporting and its general standards are similar to those of the AICPA. However, *Government Auditing Standards* also contains additional general, field work, and reporting standards, which are summarized in the table in the paragraph .03 and discussed in detail in this section.

¹ The Governmental Accounting Standards Board (GASB) has issued several pronouncements that will make significant changes in how most state and local governmental entities account for and report on their transactions and balances in the future. In addition, the AICPA Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*, addresses the audits of financial statements prepared in conformity with those GASB pronouncements. See the discussion of those GASB pronouncements and that Guide in the headnote in AAM section 12,000. This section does not incorporate the changes that might be needed as a result of those GASB pronouncements and that Guide. Those changes will be incorporated into this section in the future.

² *Government Auditing Standards* addresses two types of audits: financial and performance. Financial audits include financial statement and financial related audits. Financial statement audits are defined as providing reasonable assurance about whether the financial statements of an audited entity present fairly the financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (GAAP). Financial statement audits also include audits of financial statements prepared in conformity with other comprehensive bases of accounting discussed in paragraphs 2 through 10 of SAS No. 62, *Special Reports* (AU section 623.02-.10). This section discusses only financial statement audits.

³ Printed versions of the 1994 revision of *Government Auditing Standards* and, separately, its two amendments can be purchased from the Superintendent of Documents, U.S. Government Printing Office (GPO), Washington, DC 20401; phone (202) 512-1800; fax (202) 512-2250.

.03 Table of Additional Financial Statement Audit Requirements of *Government Auditing Standards***General Requirements**

- Continuing professional education (CPE) in subjects directly related to the government environment and to government auditing or to the specific or unique environment in which the audited entity operates (see paragraphs .05 and .06)
- Appropriate internal quality control system and external quality control review every three years (see paragraphs .07 and .08)
- Independence rules relating to personal, external, and organizational factors that are in some cases more restrictive than the AICPA's Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET section 101), particularly in the area of non-audit services (see paragraphs .09 through .12)

Fieldwork Requirements

- Communication with the organization or entity being audited (the auditee), the individuals contracting for or requesting audit services, and the audit committee regarding the nature of planned testing and reporting on compliance with laws and regulations and internal control over financial reporting (see paragraphs .13 through .15)
- Audit follow-up requirements on known material findings and recommendations from previous audits (see paragraph .16)
- Plan audit to provide reasonable assurance of detecting 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 (see paragraph .17)
- Documentation requirements when assessing control risk at maximum for controls significantly dependent upon computerized information systems (see paragraphs .18 and .19)
- Additional audit documentation requirements (see paragraphs .20 and .21)

Reporting Requirements

- Referring to *Government Auditing Standards* in the auditor's report (see paragraph .23)
- Reporting on compliance with laws and regulations and on internal control over financial reporting (see paragraphs .24 through .38)
- Consideration of privileged and confidential information (see paragraph .39)
- Report distribution (see paragraph .40)

.04 *Government Auditing Standards* also provides additional guidance on audit materiality (see paragraph .41), fraud and illegal acts (see paragraph .42), and internal control (see paragraph .43). Auditors should note that information is presented in *Government Auditing Standards* as additional guidance, and not as required standards.

General Requirements

Continuing Professional Education

.05 See *Government Auditing Standards*, paragraphs 3.6 through 3.9, for its CPE requirements. *Government Auditing Standards* requires auditors to participate in a program of CPE and training. Every two years, all auditors (whether certified or not) performing audits in accordance with *Government Auditing Standards* should complete at least eighty credit hours of training that contribute directly to their professional proficiency. At least twenty of those hours should be completed in each year of the two-year period. For auditors responsible for planning, directing, or reporting on the audit and for auditors conducting substantial portions of the audit, at least twenty-four hours should be in subjects directly related to the government environment and to government auditing. If the auditee operates in a specific or unique environment, auditors should receive training that is related to that environment. The audit organization is responsible for establishing and implementing a program to ensure that auditors meet the foregoing CPE and training requirements and for maintaining documentation of the education and training completed.

.06 *Interpretation of Continuing Education and Training Requirements*, a detailed interpretation of the foregoing CPE standards, is available from the GAO's Web site at www.gao.gov/govaud/ybk01.htm. Among other things, that interpretation discusses who is subject to the CPE requirements and what programs, activities, and subjects qualify as acceptable CPE. During engagement planning, auditors and audit organizations should ensure that members of the audit team have met or will meet the appropriate CPE requirements within two years of the start of the first audit in accordance with *Government Auditing Standards*, and every two years thereafter.

Quality Control

.07 See *Government Auditing Standards*, paragraphs 3.31 through 3.36, for its quality control requirements. *Government Auditing Standards* states that the audit organization should have in place an appropriate internal quality control system and undergo an external quality control review (for example, a peer review). An external quality control review should be conducted at least once every three years by an organization not affiliated with the organization being reviewed.

.08 *Government Auditing Standards* requires audit organizations seeking to enter into a contract to perform an audit in accordance with *Government Auditing Standards* to provide their most recent external quality control review report to the party contracting for the audit. Auditors are not required to provide separate letters of comment. Auditors should consider including in the audit documentation the provision of the quality control review report to the party contracting for the audit. Additional quality control requirements are also established by the independence rules in *Government Auditing Standards*.

Independence

.09 *Government Auditing Standards Amendment 3* (*Government Auditing Standards* paragraphs 3.11 through 3.30.10) contains independence requirements for both individual auditors and audit firms or organizations that add to those required by the AICPA for GAAS audits.* The GAO's *Government Auditing Standards: Answers to Independence Standard Questions* responds to questions related to the independence standard's implementation time frame, underlying concepts, and application in specific non-audit circumstances. Those independence requirements address when auditors and their organizations are independent from the organizations they audit by defining when personal, external, and organizational impairments to independence exist. If an audit organization is not independent, *Government Auditing Standards* states that the auditor should (a) decline to perform the work or (b) report the impairment in the scope section of the auditor's report when a government auditor cannot decline to perform the work because of a legislative requirement or for other reasons.

.10 *Government Auditing Standards* adopts an engagement-team focused approach to independence for matters such as financial interests of an individual auditor, not unlike the AICPA's requirements. It also provides criteria for when governmental audit organizations are organizationally independent from the audited entity for purposes of external and internal reporting. *Government Auditing Standards* employs a principles-based approach to independence supplemented with certain safeguards for matters such as the performance of non-audit services. With respect to non-audit services, *Government Auditing Standards* requirements are generally more restrictive than those of the AICPA.

.11 To comply with the provisions governing non-audit services, audit organizations must meet two overarching principles. The first bars audit organizations from performing management functions or making

* Amendment 3, as affected by *Government Auditing Standards. Answers to Independence Standard Questions*, is effective for audits for periods beginning on or after January 1, 2003, with early implementation encouraged. Further, in March 2003, the AICPA Professional Ethics Executive Committee released an Exposure Draft (ED) entitled *Omnibus Proposal of Professional Ethics Division Interpretations and Rulings*. Among the changes proposed in the ED are clarifications and changes relating to nonattest services to an attest client in areas such as bookkeeping services, appraisal, valuation, and actuarial services, financial information systems—design, installation, or integration services, and internal audit assistance. The changes, if finalized as proposed, would reduce some of the differences between the AICPA and *Government Auditing Standards* independence requirements.

management decisions for their clients; the second prohibits audit organizations from auditing their own work or providing non-audit services when the services are material or significant to the subject matter of the audit. If a non-audit service does not conflict with either principle, an audit organization may perform the service as long as it complies with each of the following safeguards, which are more fully described in paragraph 3.25 of *Government Auditing Standards*:

- Personnel providing the non-audit service cannot plan, conduct or review audit work related to the non-audit service. Audit and non-audit work must be performed by separate engagement teams. (When an audit organization provides 40 or fewer hours of non-audit services related to a specific audit engagement this safeguard is waived but the auditors must observe the two overarching principles and other safeguards described in this paragraph.)
- The scope and extent of audit work cannot be reduced beyond the level that would be appropriate if the non-audit work were performed by an unrelated party.
- The audit organization should document its consideration of the non-audit service, including its rationale that providing the service does not violate the two overarching principles.
- The audit organization should establish and document an understanding with management regarding the objectives, scope of work and deliverables of the non-audit service, including an understanding that management is responsible for the results of the service.
- The audit organization's quality control system should include policies and procedures that ensure consideration of the effect of the non-audit service on ongoing, planned and future audits.
- Where a non-audit service is deemed to conflict with the audit (because the service violates one or both of the overarching principles), the audit organization should communicate to management—before beginning the non-audit service engagement—that it will be unable to perform subsequent audit work related to the subject matter of the non-audit service.
- For audits selected during peer review, the audit organization should identify to its peer reviewer all related non-audit services and provide all related audit documentation.

.12 *Government Auditing Standards* describe both non-audit services that are expressly prohibited and others that are permissible (as long as the auditor complies with the two overarching principles and all required safeguards noted in paragraph .11 above). The standards also state that audit organizations can perform routine activities for the audited entity and management without impairing their independence—provided the audit organization neither makes management decisions nor perform management functions. Such ordinary services do not violate the overarching principles and are not subject to the safeguards described above.

Fieldwork Requirements

Auditor Communication

.13 See *Government Auditing Standards*, paragraphs 4.6.3 through 4.6.9, for its auditor communication requirements. *Government Auditing Standards* requires the auditor to communicate the following information to the parties identified in paragraph .14 during the planning stages of an audit:

- The auditor's responsibilities in a financial statement audit, including the responsibilities for testing and reporting on compliance with laws and regulations and internal control over financial reporting.
- The nature of any additional testing of compliance and internal control required by laws and regulations or otherwise requested, and whether the auditor is planning on providing opinions on compliance with laws and regulations and internal control over financial reporting.

To assist in communicating the limitations of the auditor's responsibilities for compliance and internal control over financial reporting, the auditor may want to contrast those responsibilities with other financial

related audits of compliance and controls. The discussion in paragraphs 4.6.8 and 4.6.9 of *Government Auditing Standards* may be helpful to auditors in explaining their responsibilities for testing and reporting on compliance with laws and regulations and internal control over financial reporting. Auditors should use professional judgment to determine the form and content of the communication, although written communication is preferred and auditors may use an engagement letter to communicate the required information.⁴ Auditors should include the communication in the audit documentation.

.14 The auditor should communicate the information in paragraph .13 to the following:

- Appropriate officials of the organization or entity being audited (the auditee) which normally would include the head of the organization, the audit committee or board of directors or other equivalent oversight body in the absence of an audit committee, and the individual who possesses a sufficient level of authority such as the chief financial officer
- In situations where the auditor is performing the audit under a contract with a party other than the auditee, or pursuant to a third-party request, the auditor should also communicate with the individuals contracting for or requesting the audit services; and
- When the auditor is performing the audit pursuant to a law or regulation, the auditor should communicate with the legislative members or staff who have oversight of the auditee. (This requirement applies only to situations where the law or regulation specifically identifies the entity to be audited. Situations where the financial statement audit mandate applies to entities not specifically identified, such as audits required by the Single Audit Act Amendments of 1996, are excluded.)

.15 Additional communication requirements related to nonaudit services are also established by the independence rules in *Government Auditing Standards*. See paragraph .11 for a description of those requirements.

Audit Follow-Up

.16 See *Government Auditing Standards*, paragraphs 4.7 and 4.10 through 4.11, for its audit follow-up requirements. *Government Auditing Standards* requires auditors to follow up on known material findings and recommendations from previous audits that could affect the financial statement audit. The purpose of this follow-up is to determine whether the auditee has taken timely and appropriate corrective actions. *Government Auditing Standards* also requires auditors to report the status of uncorrected material findings and recommendations that are from prior audits and that affect the financial statement audit.

Responsibilities With Regard to the Provisions of Contracts and Grant Agreements

.17 Paragraph 4.13 of *Government Auditing Standards* refers to additional responsibilities with regard to detecting material misstatements resulting from noncompliance with the provisions of contract and grant agreements that have a direct and material effect on the determination of financial statement amounts. However, it generally has been interpreted under GAAS that the phrase *laws and regulations* in SAS No. 54, *Illegal Acts by Clients* (AU section 317), implicitly includes the provisions of contracts and grant agreements. Thus, the auditor's responsibility with regard to detecting material misstatements resulting from noncompliance with the provisions of contracts and grant agreements under *Government Auditing Standards* equates to the auditor's responsibility under GAAS.

Internal Control Documentation Requirement

.18 See paragraphs 4.21.3 and 4.21.4 of *Government Auditing Standards* for an additional internal control standard that requires auditors, when planning the audit, to include the following in the audit documentation:

⁴ Note that using the engagement letter to make the required communication does not satisfy *Government Auditing Standards* requirements if the letter is not delivered to the parties identified in paragraph .13

- 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 upon computerized information systems; and
- Consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level.

.19 That additional standard does not increase the auditor's responsibility for testing controls. However, it may require additional documentation. If the auditor assesses 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 upon computerized information systems, the auditor should include in the audit documentation the basis for that conclusion by addressing (a) the ineffectiveness of the design and/or operation of the controls or (b) the reasons why it would be inefficient to test the controls. In such circumstances, *Government Auditing Standards* also requires the auditor to include in the audit documentation the consideration that the planned audit procedures are designed to achieve specific audit objectives and, accordingly, to reduce audit risk to an acceptable level. That documentation should address:

- The rationale for determining the nature, timing, and extent of planned audit procedures;
- The kinds and competence of available evidential matter produced outside a computerized information system; and
- The effect on the audit opinion or report if evidential matter to be gathered during the audit does not afford a reasonable basis for the auditor's opinion on the financial statements.

Audit Documentation

.20 See *Government Auditing Standards*, paragraph 4.35, for an additional standard that requires audit documentation to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments. *Government Auditing Standards*, paragraph 4.38, also states that auditors should provide for audit documentation access to audit documentation by other auditors. Providing for such access in contractual arrangements for *Government Auditing Standards* audits will help to facilitate reviews of audit quality and reliance by other auditors on the auditor's work.

.21 *Government Auditing Standards*, paragraph 4.37, specifically states that audit documentation should contain—

- The objectives, scope, and methodology, including any sampling criteria used.
- Documentation of the work performed to support significant conclusions and judgments, including descriptions of the transactions and records examined that would enable an experienced auditor to examine the same transactions and records. [Auditors may meet this requirement by listing voucher numbers, check numbers, or other means of identifying specific documents they examined. Auditors are not required to include in the audit documentation copies of documents they examined nor are they required to list detailed information from those documents.]
- Evidence of supervisory reviews of the work performed.

.22 Additional documentation requirements related to non-audit services are also established by the independence rules in *Government Auditing Standards*. See paragraph .11 for a description of those requirements.

Reporting Requirements

Reference to *Government Auditing Standards*

.23 When the report on the financial statements is submitted to comply with a requirement for an audit in accordance with *Government Auditing Standards*, audit reports should state that the audit was made in accordance with generally accepted government auditing standards. (See *Government Auditing Standards*, paragraphs 5.11 through 5.14.) The AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, recommends the following language be included in the auditor's report to meet this requirement: "we conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States."⁵

Compliance and Internal Control Reporting⁶

.24 *Government Auditing Standards* requires the report on the audit of the financial statements to either (a) describe the scope of the auditor's testing of compliance with laws and regulations and internal control over financial reporting and present the results of those tests or (b) refer to the separate report(s) containing that information. In presenting the results of tests, the auditor should report fraud, illegal acts, other material noncompliance, and reportable conditions in internal control over financial reporting. The AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, recommends a separate, single report on compliance and on internal control over financial reporting, the elements of which are presented in a table in paragraph .38. Illustrative reports on compliance and on internal control over financial reporting are in AAM sections 12,400.18 and 12,400.19.

.25 When auditors report separately on compliance with laws and regulations and internal control over financial reporting, the report on the financial statements should state that they have issued the additional report. It also should state that the report on compliance with laws and regulations and internal control over financial reporting is an integral part of an audit performed in accordance with *Government Auditing Standards*, and in considering the results of the audit, that the report(s) should be read in conjunction with the auditor's report on the financial statements. See footnote 3 in the illustrative auditor's report on the financial statements in AAM section 12,400.01 for the language to refer to a separate report on compliance and on internal control over financial reporting. A listing of the elements of an auditor's report on a government's financial statements that is issued for an audit in accordance with GAAS and *Government Auditing Standards* is in the table in the following paragraph.

.26 Table of Elements of an Auditor's Report on Financial Statement Issued in Accordance With *Government Auditing Standards*

If the auditor's report on a government's financial statement is issued for an audit in accordance with GAAS and *Government Auditing Standards* (and not for an audit subject to Circular A-133), the standard report identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion on the financial statements in a separate opinion paragraph. The basic elements of the report are—

- a. A title that includes the word *independent*.
- b. A statement that the financial statements identified in the report were audited.

(continued)

⁵ *Government Auditing Standards* acknowledges that an auditee may need a financial statement audit for purposes other than to comply with a requirement calling for an audit in accordance with *Government Auditing Standards*. For example, the auditee may need a financial statement audit to issue bonds. In this case, *Government Auditing Standards* permits auditors to issue a separate report on the financial statements conforming only to the requirements of GAAS.

⁶ See paragraphs 5.15 through 5.28 of *Government Auditing Standards*.

- c. A statement that the financial statements are the responsibility of the auditee's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit.
- d. A statement that the audit was conducted in accordance with GAAS and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U. S. generally accepted auditing standards) and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.⁷
- e. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
- f. A statement that an audit includes—
 - Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
 - Assessing the accounting principles used and significant estimates made by management.
 - Evaluating the overall financial statement presentation.
- g. A statement that the auditor believes that the audit provides a reasonable basis for his or her opinion.
- h. An opinion on whether the financial statements present fairly, in all material respects, the financial position of the auditee as of the balance sheet date, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the period then ended in conformity with GAAP.⁸ The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles).
- i. A reference to the separate report on compliance with certain provisions of laws, regulations, contracts, and grant agreements and on the internal control over financial reporting prepared in accordance with *Government Auditing Standards* (see paragraph .36) that includes a statement that the separate report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with the report on the financial statements in considering the results of the audit. If the reporting on compliance and internal control over financial reporting is included in the report on the financial statements, the reference to the separate report is not required. (The AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, recommends separate reporting. See paragraph .24.)
- j. A description of the accompanying required supplementary information (for example, certain pension or risk financing information) and supplementary information (for example, the combining and individual fund and account group financial statements and schedules). This identification may be by descriptive title or by page number of the document.⁹

⁷ If a material component unit or fund of a reporting entity is not required to have an audit in accordance with *Government Auditing Standards*, but the audit of the reporting entity is performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of the report on the financial statements to indicate the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation is: "We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of [name of fund or component unit] were not audited in accordance with *Government Auditing Standards*. An audit includes examining . . ."

⁸ If a government prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP, the auditor is still required to express or disclaim an opinion and should follow the reporting in SAS No. 62, *Special Reports*.

⁹ SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, as amended (AU section 551), requires the elements listed in items j through l in auditor-submitted documents that contains information in addition to the client's basic financial statements and the auditor's report thereon. In addition, if the document is client prepared, the auditor may be engaged or choose to apply the guidance in SAS No. 29, as amended. Other guidance on the auditor's responsibility with respect to such information is in (a) SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, as amended (AU section 550), and (b) SAS No. 52, *Required Supplementary Information*, as amended (AU section 558).

- k. A statement that the accompanying information is presented for purposes of additional analysis and is not a required part of the financial statements.
- l. An opinion on whether the accompanying information is fairly stated, in all material respects, in relation to the financial statements taken as a whole, or a disclaimer of opinion, depending on whether the information has been subjected to the auditing procedures applied in the audit of the basic financial statements. The auditor may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.
- m. The manual or printed signature of the auditor's firm.
- n. The date of the audit report.

Fraud, Illegal Acts, and Other Noncompliance

.27 With regard to fraud and illegal acts, *Government Auditing Standards* requires auditors to report relevant information (in writing) when the auditor concludes, based on evidence obtained, that fraud or an illegal act has occurred or is likely to have occurred. Auditors do not need to report information about fraud or illegal acts that is clearly inconsequential. Therefore, auditors are required to present in the report the same fraud and illegal acts that they report to audit committees under GAAS.¹⁰ *Government Auditing Standards* also requires auditors to report other noncompliance (for example, a violation of a contract provision) that is material to the financial statements.

.28 When auditors detect fraud, illegal acts, or other noncompliance that do not meet the criteria in paragraph 5.18 of *Government Auditing Standards* for reporting (summarized in paragraph .21), paragraph 5.20 of *Government Auditing Standards* requires auditors to communicate those findings to the auditee, preferably in writing. If auditors have communicated those findings in a management letter to top management, they should refer to that management letter when they are reporting on compliance. Auditors should document in their working papers all communications to the auditee about fraud, illegal acts, or other noncompliance.

.29 In some circumstances, *Government Auditing Standards* requires the auditor to report fraud and illegal acts directly to parties external to the audited entity. (See *Government Auditing Standards*, paragraphs 5.21 through 5.25.) In addition to any legal requirements for the direct reporting of fraud or illegal acts, auditors (even if they have resigned or been dismissed from the audit) must report fraud or illegal acts directly to parties outside the auditee in the following two circumstances:

- a. The auditee may be required by law or regulation to report certain fraud or illegal acts to specified external parties (for example, to a federal inspector general or a state attorney general). If auditors have communicated such fraud or illegal acts to the auditee, and it fails to report them, then auditors should communicate their awareness of that failure to the auditee's governing body. If the auditee does not make the required report as soon as practicable after the auditors' communication with its governing body, the auditors should report the fraud or illegal acts directly to the external party specified in the law or regulation.
- b. When fraud or an illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to take remedial steps. If auditors conclude that such failure is likely to cause them to depart from the standard report on the financial statement or resign from the audit, then they should communicate that conclusion to the auditee's governing body. Then, if the auditee does not report the fraud or illegal act as soon as practicable to the entity that provided the government assistance, the auditors should report the fraud or illegal act directly to that entity.

¹⁰ See SAS No. 54, *Illegal Acts by Clients* (AU section 317) and SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AU section 316).

In both of these situations, auditors should obtain sufficient, competent, and relevant evidence (for example, by confirmation with outside parties) to corroborate assertions by management that it has reported fraud or illegal acts. If they are unable to do so, the auditors should report the fraud or illegal acts directly, as discussed previously.

.30 Paragraph 4.16 of *Government Auditing Standards* reminds auditors that under some circumstances, laws, regulations, or policies may require them to report indications of certain types of fraud or illegal acts promptly to law enforcement or investigatory authorities. When auditors conclude that this type of fraud or illegal act either has occurred or is likely to have occurred, they should ask those authorities, legal counsel, or both, if reporting certain information about that fraud or illegal act would compromise investigative or legal proceedings. Auditors should limit their reporting to matters that would not compromise those proceedings, such as information that is already a part of the public record.

Internal Control Over Financial Reporting

.31 The auditor's report on internal control over financial reporting does not express an opinion on the auditee's internal control over financial reporting, but rather describes the extent of the work performed, as required by SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319), as amended. The report should encompass the requirements of SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended (AU section 325), as well as the additional requirements of *Government Auditing Standards*.

.32 *Government Auditing Standards*, paragraph 5.26, requires auditors to report deficiencies in internal control that they consider to be reportable conditions as defined by SAS No. 60, as amended, and gives examples of matters that may be reportable conditions.¹¹ In reporting reportable conditions, auditors are required to identify those that are individually or cumulatively material weaknesses. The illustrative report in AAM section 12,400.19 provides recommended language that satisfies the requirements of *Government Auditing Standards* when reportable conditions (whether or not they are considered to be material weaknesses) are noted during an audit.

.33 *Government Auditing Standards*, paragraph 5.28, states that when auditors detect deficiencies in the internal control that are not reportable conditions, they should communicate those deficiencies to the auditee, preferably in writing. If the auditors have communicated those deficiencies in internal control in a management letter to top management, they should refer to that management letter when they report on internal control. The illustrative reports in AAM section 12,400.18 and .19 illustrate such a reference to the management letter. Paragraph 5.28 of *Government Auditing Standards* also requires the auditor to document all communications to the auditee about deficiencies in internal control.

Follow-up on Prior-Audit Findings

.34 See paragraph .11 for a discussion of the auditor's responsibility for audit follow-up under *Government Auditing Standards*, including the reporting responsibility.

Findings and Report Content

.35 *Government Auditing Standards*, paragraph 5.19, states that in reporting fraud, illegal acts, other noncompliance, and reportable conditions in internal control, auditors should place their findings in proper perspective. This perspective is both quantitative and qualitative. To give the reader a basis to judge the prevalence and consequences of these conditions, the instances that are identified should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate.

¹¹ Paragraph 17 of SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AU section 325.17) prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. The illustrative report in AAM section 12,400.18 provides recommended language that satisfies the requirements of *Government Auditing Standards* when no reportable conditions are noted during an audit.

.36 *Government Auditing Standards* suggests that well-developed findings generally include criteria (what should be), the condition (what is), the effect (the difference between what is and what should be), and the cause (why it happened). *Government Auditing Standards* recognizes reportable conditions and noncompliance identified by the auditor may not always have all of the elements fully developed. However, to provide sufficient information to users to permit them to determine the effect and cause in order to take prompt and proper corrective action, auditors should identify at least the criteria, condition, and possible asserted effect.

.37 In presenting reportable conditions, fraud, illegal acts, and other noncompliance, auditors should follow the report content standards in chapter 7 of *Government Auditing Standards* that pertain to objectives, scope, and methodology; audit results; the views of responsible officials; and the reports presentation standards (as appropriate). Auditors may provide less extensive disclosure of fraud and illegal acts that are not material in either a quantitative or qualitative sense.

.38 Table of Elements of an Auditor's Report on Compliance and on Internal Control Over Financial Reporting Issued in Accordance with *Government Auditing Standards*

The basic elements of the auditor's standard report on compliance and on the internal control over financial reporting based on an audit of the financial statements in accordance with *Government Auditing Standards* (and not for an audit subject to Circular A-133), are—

- a. A statement that the auditor has audited the financial statements of the auditee and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the audit was conducted in accordance with GAAS and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U. S. generally accepted auditing standards) and with the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.¹²
- c. A statement that as part of obtaining reasonable assurance about whether the auditee's financial statements are free of material misstatement, the auditor performed tests of the auditee's 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.
- d. A statement that providing an opinion on compliance with those provisions was not an objective of the audit and that, accordingly, the auditor does not express such an opinion.
- e. A statement that notes whether the results of tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards* and, if they are, describes the instances of noncompliance or refers to a separate schedule that summarizes the findings. (See paragraph .21 for a discussion of noncompliance matters that need to be reported under *Government Auditing Standards*.)
- f. If applicable, a statement that certain immaterial instances of noncompliance were communicated to management in a separate letter. (See paragraph .28 for a discussion of reporting other noncompliance matters to top management in accordance with *Government Auditing Standards*.)
- g. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over financial reporting in order to determine the auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.

(continued)

¹² If a material component unit or fund of a reporting entity is not required to have an audit in accordance with *Government Auditing Standards*, but the audit of the reporting entity is performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of the report on compliance and on internal control to indicate the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation follows: We have audited the financial statements of Example Entity as of and for the year ended June 30, XXX1, and have issued our report thereon dated August 15, XXX1. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The financial statements of [name of fund or component unit] were not audited in accordance with *Government Auditing Standards*.

- h. If applicable, a statement that reportable conditions were noted and the definition of a reportable condition.
- i. If no reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses; if reportable conditions are noted, a statement that the auditor's 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 that are also considered to be material weaknesses.
- j. If applicable, a description of the reportable conditions noted or a reference to a separate schedule that summarizes the findings.
- k. The definition of a material weakness.
- l. If applicable, a statement about whether the auditor believes any of the reportable conditions noted are material weaknesses and, if they are, describes the material weaknesses noted or refers to a separate schedule that summarizes the findings. If there are no reportable conditions noted, a statement is made that no material weaknesses were noted.
- m. If applicable, a statement that other matters involving the internal control over financial reporting were communicated to management in a separate letter. (See paragraph .33 for a discussion of other internal control matters to be communicated to top management in accordance with *Government Auditing Standards*.)
- n. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of the audit committee, management, and specified legislative or regulatory bodies and is not intended to be and should not be used by anyone other than these specified parties.
- o. The manual or printed signature of the auditor's firm.
- p. The date of the auditor's report.¹³

Privileged and Confidential Information

.39 *Government Auditing Standards*, paragraphs 5.29 through 5.31, require that if certain information is prohibited from general disclosure (that is, prohibited from general disclosure by federal, state, or local laws or regulations), the audit report should state the nature of the information omitted and the requirement that makes the omission necessary.

Report Distribution

.40 *Government Auditing Standards* requires written audit reports to be submitted by the audit organization to the appropriate officials of the auditee and to the appropriate officials of the organizations requiring or arranging for the audit (including external funding organizations), unless legal restrictions prevent it. (See *Government Auditing Standards*, paragraphs 5.32 through 5.35.) Copies of the reports also should be sent to 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. Unless restricted by law or regulation, copies should be made available for public inspection. When public accountants are engaged, the engaging organization should ensure that the report is distributed appropriately. If the public accountants are to make the distribution, the engagement agreement should indicate which officials or organizations should receive the report.

Additional Guidance

Audit Materiality

.41 Paragraphs 4.6.1 and 4.6.2 of *Government Auditing Standards* state that "auditors' consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable

¹³ Because the report on compliance and internal control over financial reporting, as required by *Government Auditing Standards*, relates to the audit of the financial statements and is based on the GAAS audit procedures performed, it should carry the same date as on the report on these financial statements.

person who will rely on the financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. In an audit of the financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.”

Fraud and Illegal Acts

.42 *Government Auditing Standards*, paragraphs 4.14 through 4.17, provides additional guidance on possible fraud and illegal acts. First, *Government Auditing Standards* states that auditors may find it necessary to use the work of legal counsel in (1) determining which laws and regulations might have a direct and material effect on the financial statements, (2) designing tests of compliance with laws and regulations, and (3) evaluating the results of those tests. Auditors also may find it necessary to use the work of legal counsel when an audit requires testing compliance with provisions of contracts or grant agreements. Depending on the circumstances, auditors may need to obtain information on compliance matters from others, such as investigative staff, audit officials of government entities that provided assistance to the auditee, or the applicable law enforcement authority. Second, *Government Auditing Standards* provides guidance on exercising due care in pursuing indications of possible fraud and illegal acts so as not to interfere with potential future investigations, legal proceedings, or both, as discussed in paragraph .24.

Internal Control

.43 Paragraphs 4.21 through 4.30 of *Government Auditing Standards* provide guidance on certain aspects of internal control over financial reporting that are important to the judgments auditors make about audit risk and about the evidence needed to support their opinion on the financial statements. Those aspects are summarized as follows:

- *Safeguarding of assets.* These are the controls that prevent or timely detect unauthorized transactions and unauthorized access to assets resulting in possible losses that are material to the financial statements. Therefore, the understanding of safeguarding controls assists auditors in planning the audit to detect material misappropriations as well as to assess other risks that the financial statements could be materially misstated.
- *Control over compliance with laws and regulations.* These are important to auditors in identifying the types of potential misstatements that could occur and the factors that could affect the risk of material misstatement. Such information can help 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.

[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

Note: The Governmental Accounting Standards Board (GASB) has issued several pronouncements that will make significant changes in how most state and local governmental entities account for and report on their transactions and balances in the future. These auditors' reports do not incorporate the changes that will result from those GASB pronouncements. Appendix A to Chapter 14 of the AICPA Audit and Accounting Guide *Audits of State and Local Governments (GASB 34 Edition)*, contains auditors' reports reflecting the necessary changes. See the discussion of those GASB pronouncements and that Guide in the headnote in AAM section 12,000.

.01 Unqualified Opinion on General-Purpose Financial Statements¹

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, 20X1, 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 auditing standards generally accepted in the United States of America.² Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 20X1, and the results of its operations

¹ The financial statements of a component unit should acknowledge that the component unit is a component unit of another government; for example, "We have audited the accompanying general-purpose financial statements of Sample County School District, component unit of Sample County, as of and for the year ended June 30, 20X1." 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." (See AAM section 12,400.04.)

² When the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for an audit in accordance with *Government Auditing Standards*, insert the phrase "and 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*.

and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with accounting principles generally accepted in the United States of America.³

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.1, with conforming changes as of May 1, 2003.]

³ When the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for an audit in accordance with *Government Auditing Standards*, a paragraph similar to the following should be added after the opinion paragraph:

In accordance with *Government Auditing Standards*, we have also issued 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. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

.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-purpose¹ financial statements of the City of Example, Any State, as of and for the year ended June 30, 20X1, 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 auditing standards generally accepted in the United States of America.² Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 20X1, 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 accounting principles generally accepted in the United States of America.³

Our audit was conducted for the purpose of forming an opinion on the general-purpose financial statements of the City of Example, Any State. 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. 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.⁴

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.2, with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 1.

² See AAM section 12,400.01, footnote 2.

³ See AAM section 12,400.01, footnote 3.

⁴ When reporting on supplementary data, the auditor should consider the effect of any modifications in the report on the general-purpose financial statements. 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*, as amended (AU section 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-purpose¹ 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, 20X1, 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 auditing standards generally accepted in the United States of America.² Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 20X1, 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 accounting principles generally accepted in the United States of America. 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, 20X1, 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 accounting principles generally accepted in the United States of America.³

Our audit was conducted for the purpose of forming an opinion on the general-purpose, combining, and individual fund and account group financial statements of the City of Example, Any State. 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 those financial statements. 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.⁴

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.3, with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 1.

² See AAM section 12,400.01, footnote 2.

³ See AAM section 12,400.01, footnote 3.

⁴ See AAM section 12,400.02, footnote 4.

.04 Report on Primary Government Financial Statements That Omit the Financial Data of Each Component Unit

Independent Auditor's Report

Addressee:

We have audited the accompanying primary government financial statements of the City of Example, Any State, as of and for the year ended June 30, 20X1, 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 auditing standards generally accepted in the United States of America.¹ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, 20X1, 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 accounting principles generally accepted in the United States of America.

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, 20X1, 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 accounting principles generally accepted in the United States of America.²

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.4, with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 2.

² See AAM section 12,400.01, footnote 3.

.05 Qualified Opinion on General-Purpose Financial Statements That Omit One or More, But Not All, Component Units of the Financial Reporting Entity

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose¹ financial statements of the City of Example, Any State, as of and for the year ended June 30, 20X1, 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 auditing standards generally accepted in the United States of America.² Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

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 accounting principles generally accepted in the United States of America. If the omitted component unit(s) had been included,³ 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, 20X1, 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 accounting principles generally accepted in the United States of America.⁴

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.5, with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 1.

² See AAM section 12,400.01, footnote 2.

³ If the amounts applicable to the omitted component unit have not been audited, insert the phrase *based on unaudited information*.

⁴ See AAM section 12,400.01, footnote 3.

.06 Adverse Opinion on General-Purpose Financial Statements That Omit One or More, But Not All, Component Units of the Financial Reporting Entity

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose financial statements¹ of City of Example, Any State, as of and for the year ended June 30, 20X1, 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 auditing standards generally accepted in the United States of America.² Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

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 accounting principles generally accepted in the United States of America.

Because of the departure from generally accepted accounting principles identified above, as of June 30, 20X1, 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 accounting principles generally accepted in the United States of America, the financial position of City of Example, Any State as of June 30, 20X1, 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 (Non-GASB 34 Edition)*, Appendix A, Example A.5, footnote 14, with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 1.

² See AAM section 12,400.01, footnote 2.

.07 Qualified Opinion on General-Purpose Financial Statements That Omit a Fund Type or Account Group¹

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose² financial statements of the City of Example, Any State, as of and for the year ended June 30, 20X1, 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 auditing standards generally accepted in the United States of America.³ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 accounting principles generally accepted in the United States of America. The omitted fund type⁴ 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, 20X1, 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 accounting principles generally accepted in the United States of America.⁵

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.6, with conforming changes as of May 1, 2003.]

¹ There may be circumstances when, based on professional judgment, the auditor may determine that an adverse opinion on the general-purpose financial statements is appropriate. In such a case, a separate explanatory paragraph should state all the substantive reasons for the adverse opinion and the principal effects of those matters. If an adverse opinion is to be rendered, the last two paragraphs of this report should be replaced with the following paragraphs:

The general-purpose financial statements referred to above do not include financial data of the *[identify the component unit(s) omitted]*, which should be included in order to conform with accounting principles generally accepted in the United States of America. Because of the departure from generally accepted accounting principles identified above, as of June 30, 20X1, 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 accounting principles generally accepted in the United States of America, the financial position of City of Example, Any State, as of June 30, 20X1, or the result of its operations or the cash flows of its proprietary fund types and nonexpendable trust funds of the year then ended.

² See AAM section 12,400.01, footnote 1.

³ See AAM section 12,400.01, footnote 2.

⁴ If the amounts applicable to the omitted fund type or account group have not been audited, insert the phrase *based on unaudited information*.

⁵ See AAM section 12,400.01, footnote 3.

.08 Qualified Opinion on General-Purpose Financial Statements That Omit a Fund From a Fund Type¹

Independent Auditor's Report

Addressee:

We have audited the accompanying general-purpose² financial statements of the City of Example, Any State, as of and for the year ended June 30, 20X1, 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 auditing standards generally accepted in the United States of America.³ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 accounting principles generally accepted in the United States of America. If the omitted fund⁴ 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, 20X1, 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 accounting principles generally accepted in the United States of America.⁵

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.7, with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.07, footnote 1.

² See AAM section 12,400.01, footnote 1.

³ See AAM section 12,400.01, footnote 2.

⁴ If the amounts applicable to the omitted fund have not been audited, insert the phrase *based on unaudited information*.

⁵ See AAM section 12,400.01, footnote 3.

.09 Unqualified Opinion on General Fund Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the general fund of the City of Example, Any State, as of and for the year ended June 30, 20X1, 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 auditing standards generally accepted in the United States of America.¹ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 accounting principles generally accepted in the United States of America.

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, 20X1, and the results of its operations for the year then ended in conformity with accounting principles generally accepted in the United States of America.²

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.8, with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 2.

² See AAM section 12,400.01, footnote 3.

.10 Unqualified Opinion on an Enterprise Fund's Financial Statements With an Explanatory Paragraph Calling Attention to the Fact That the Financial Statements Do Not Represent the Financial Position and Results of Operations of the Financial Reporting Entity

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of [*identify enterprise fund*] of the City of Example, Any State, as of and for the year ended June 30, 20X1, 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 auditing standards generally accepted in the United States of America.¹ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 accounting principles generally accepted in the United States of America.

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, 20X1, and the results of its operations and the cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.²

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.9, with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 2.

² 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-purpose¹ financial statements of the City of Example, Any State, as of and for the year ended June 30, 20X1, 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 auditing standards generally accepted in the United States of America.² Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

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, 20X1, 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 accounting principles generally accepted in the United States of America.³

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.11, with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 1.

² See AAM section 12,400.01, footnote 2.

³ See AAM section 12,400.01, footnote 3.

.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-purpose¹ financial statements of the City of Example, Any State, as of and for the year ended June 30, 20X1, 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 auditing standards generally accepted in the United States of America.² Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 20X1, 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 accounting principles generally accepted in the United States of America.³

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.12(A), with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 1

² See AAM section 12,400.01, footnote 2.

³ See AAM section 12,400.01, footnote 3.

.13 Unqualified Opinion on General-Purpose Financial Statements 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-purpose¹ 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, 20X1, 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, 20X1, 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 auditing standards generally accepted in the United States of America.² Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 20X1, 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 accounting principles generally accepted in the United States of America. 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, 20X1, 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 accounting principles generally accepted in the United States of America.³

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.12(B), with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 1.

² See AAM section 12,400.01, footnote 2.

³ See AAM section 12,400.01, footnote 3.

.14 Unqualified Opinion on General-Purpose Financial Statements 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-purpose¹ financial statements of the City of Example, Any State, as of and for the year ended June 30, 20X1, 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 auditing standards generally accepted in the United States of America.² Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audit and the report of other auditors, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of City of Example, Any State, as of June 30, 20X1, 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 accounting principles generally accepted in the United States of America.³

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.13, with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 1.

² See AAM section 12,400.01, footnote 2.

³ See AAM section 12,400.01, footnote 3.

.15 Unqualified Opinion on 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, 20X1, 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 auditing standards generally accepted in the United States of America.¹ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 accounting principles generally accepted in the United States of America.

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, 20X1, and the revenues it received and expenditures it paid for the year then ended on the basis of accounting described in Note X.^{2,3}

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.14, with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 2.

² If the financial statements are prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject, the opinion paragraph should be followed by a paragraph that restricts the distribution of the report solely to those within the entity and for filing with the regulatory agency. See paragraphs 5f and 8 of SAS No. 62, *Special Reports* (AU section 623.05f and .08)

³ 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, 20X1, 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 auditing standards generally accepted in the United States of America.¹ Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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, 20X1, and the results of its operations and the cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.²

[Signature]

[Date]

[Source: AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, Appendix A, Example A.15, with conforming changes as of May 1, 2003.]

¹ See AAM section 12,400.01, footnote 2.

² See AAM section 12,400.01, footnote 3

.17 Unqualified Opinion on General-Purpose Financial Statements and Supplementary Schedule of Expenditures of Federal Awards (Non-GASB 34 Version)¹

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, 20X1, 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 auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,² 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, 20X1, 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 accounting principles generally accepted in the United States of America.

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. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.³

Our audit was conducted for the purpose of forming an opinion on the general-purpose financial statements taken as a whole. The accompanying schedule of expenditures of federal awards⁴ 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.⁵

¹ Auditors also should refer to the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units (Non-GASB 34 Edition)*, for additional guidance on reporting on a government's general-purpose financial statements.

² The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

³ 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

⁴ 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 AAM section 12,400.02 and .03 and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, as amended (AU section 551), provide useful guidance.

⁵ 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, as amended (AU section 551.09-11, 13, and .14).

[Signature]

[Date]

[Source: AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 1a, with conforming changes as of May 1, 2003.]

.18 Report on Compliance and on Internal Control Over Financial Reporting¹ 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])²

Independent Auditor's Report

Addressee:

We have audited the financial statements of Example Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated August 15, 20X1.³ We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,⁴ 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*.^{5,6}

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 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.⁷

¹ See paragraph 4.12 of the AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, for a description of internal control over financial reporting.

² The auditor should use the portions of AAM section 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.

³ 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)

⁴ See AAM section 12,400.17, footnote 2.

⁵ See paragraphs 5.18 and 5.19 of *Government Auditing Standards* for the criteria for reporting.

⁶ 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, 20X1." 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.

⁷ 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, 20X1." 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.^{8, 9}

[*Signature*]

[*Date*]

[Source: AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 2, with conforming changes as of May 1, 2003.]

⁸ 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."

⁹ This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AU section 532). See SAS No. 87 for additional guidance on restricted-use reports.

.19 Report on Compliance and on Internal Control Over Financial Reporting¹ Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards* (Reportable Instances of Noncompliance and Reportable Conditions Identified)²

Independent Auditor's Report

Addressee:

We have audited the financial statements of Example Entity as of and for the year ended June 30, 20X1, and have issued our report thereon dated August 15, 20X1.³ We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*,⁴ 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*⁵ 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, 20X1-2 and 20X1-5].⁶

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, 20X1-1, 20X1-4, and 20X1-8].

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

¹ See AAM section 12,400.18, footnote 1.

² See AAM section 12,400.18, footnote 2.

³ See AAM section 12,400.18, footnote 3.

⁴ See AAM section 12,400.17, footnote 2.

⁵ See AAM section 12,400.18, footnote 5.

⁶ 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, 20X1." 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.^{7,8}

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.^{9,10}

[Signature]

[Date]

[Source: AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 2a, with conforming changes as of May 1, 2003.]

⁷ 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, 20X1-1 and 20X1-8*] to be material weaknesses."

⁸ 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, 20X1." 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.

⁹ 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."

¹⁰ 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])¹

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, 20X1. 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 auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,² 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, 20X1. 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, 20X1-3 and 20X1-6].³

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

¹ 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.

² See AAM section 12,400.17, footnote 2.

³ 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.⁴

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.⁵

[Signature]

[Date]

[Source: AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 3, with conforming changes as of May 1, 2003.]

⁴ As noted in AAM section 12,400.17, footnote 3, 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, 20X1, and have issued our report thereon dated August 15, 20X1. 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 AAM section 12,400.17, footnote 5 for additional guidance.

⁵ 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)¹

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, 20X1. 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 auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,² 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, 20X1-10] 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, 20X1.³

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.

¹ See AAM section 12,400.20, footnote 1.

² See AAM section 12,400.17, footnote 2.

³ 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, 20X1-3 and 20X1-6]."

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, 20X1-7, 20X1-8, and 20X1-9]*.

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.^{4,5}

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.⁶

[Signature]

[Date]

[Source: AICPA Audit Guide Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards, Appendix D, Example 3a, with conforming changes as of May 1, 2003.]

⁴ See AAM section 12,400.19, footnote 7.

⁵ See AAM section 12,400.20, footnote 4.

⁶ 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, 20X1. 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 auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,¹ 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, 20X1.²

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

¹ See AAM section 12,400.17, footnote 2.

² 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, 20X1-7, 20X1-8, and 20X1-9].

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.^{3, 4}

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.⁵

[Signature]

[Date]

[Source: AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 4, with conforming changes as of May 1, 2003.]

³ See AAM section 12,400.19, footnote 7.

⁴ See AAM section 12,400.20, footnote 4.

⁵ 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, 20X1. 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 auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,¹ 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, 20X1-10, 20X1-11, and 20X1-12] 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, 20X1.²

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

¹ See AAM section 12,400.17, footnote 2.

² See AAM section 12,400.21, footnote 3.

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, 20X1-7, 20X1-8, and 20X1-9]*.

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 20X1-8 and 20X1-9]* to be material weaknesses.³

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.⁴

[Signature]

[Date]

[Source: AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 5, with conforming changes as of May 1, 2003.]

³ See AAM section 12,400.20, footnote 4.

⁴ 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, 20X1. 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.¹

We conducted our audit in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,² 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 above³ presents fairly, in all material respects, the expenditures of federal awards under the [identify the federal program] in conformity with accounting principles generally accepted in the United States of America.^{4, 5}

[Signature]

[Date]

[Source: AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 6, with conforming changes as of May 1, 2003.]

¹ 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 of the AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, for a discussion of the possible need to issue a separate report to meet the reporting requirements of *Government Auditing Standards*.

² See AAM section 12,400.17, footnote 2.

³ 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.

⁴ The auditor should follow the guidance in SAS No. 62, *Special Reports* (AU section 623), when the auditee prepares the financial statement of the program in conformity with a basis of accounting other than GAAP.

⁵ If a separate report is issued to meet the reporting requirements of *Government Auditing Standards* (see paragraph 11.10 of the AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*), 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-133¹ (Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified])²

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, 20X1. 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 auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*,³ 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, 20X1. 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, 20X1-1 and 20X1-2].⁴

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.

¹ 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 11.04 of the AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, for a discussion of the auditor's responsibility when a program-specific audit guide is not current).

² 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.

³ See AAM section 12,400.17, footnote 2.

⁴ 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.⁵

[Signature]

[Date]

[Source: AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix D, Example 6a, with conforming changes as of May 1, 2003.]

⁵ 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, 20X1

Section I—Summary of Auditor's Results

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*]:¹

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:²

CFDA Number(s)³

Name of Federal Program or Cluster⁴

Dollar threshold used to distinguish between type A and type B programs: \$ _____

Auditee qualified as low-risk auditee? _____ yes _____ no

¹ 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."

² Major programs should generally be identified in the same order as reported on the schedule of expenditures of federal awards.

³ When the CFDA number is not available, include other identifying number, if applicable.

⁴ 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.

Section II—Financial Statement Findings

[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.⁵ 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
- Context⁶
- Effect
- Cause
- Recommendation
- Management's response⁷

Section III—Federal Award Findings and Questioned Costs

[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 material 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.⁸ 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 program⁹
- Criteria or specific requirement (including statutory, regulatory, or other citation)

⁵ 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 20X1 would be assigned reference numbers of 20X1-1, 20X1-2, etc.

⁶ 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.

⁷ 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.

⁸ See footnote 5.

⁹ 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*¹⁰
- *Questioned costs*¹¹
- *Context*¹²
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response*¹³

[Source: AICPA Audit Guide *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, Appendix E, with conforming changes as of May 1, 2003.]

¹⁰ Include facts that support the deficiency identified in the audit finding.

¹¹ Identify questioned costs as required by sections 510(a)(3) and 510(a)(4) of Circular A-133.

¹² See footnote 6.

¹³ 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 (Non-GASB 34 Edition)*

Independent Auditor's Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the general-purpose financial statements of [City of Example] as of and for the year ended June 30, 20X1 (not presented herein), and have issued our report thereon dated August 15, 20X1.¹

As explained in Note [x], the accompanying summary financial information of [City of Example], as of and for the year ended June 30, 20X1, is not a presentation in conformity with accounting principles generally accepted in the United States of America. 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 (Non-GASB 34 Edition)*, Appendix A, Example A.17, with conforming changes as of May 1, 2003.]

¹ 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 (Non-GASB 34 Edition)*

Independent Auditor's Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the general-purpose financial statements of [City of Example] as of and for the year ended June 30, 20X1 (not presented herein), and have issued our report thereon dated August 15, 20X1.¹

As explained in Note [x], the accompanying summary financial information of [City of Example], as of and for the year ended June 30, 20X1, is not a presentation in conformity with accounting principles generally accepted in the United States of America. Furthermore, the summary financial information has been prepared [specify reason(s) for adverse report, for example, using a different measurement focus and basis of accounting² 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, 20X1, 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 (Non-GASB 34 Edition)*, Appendix A, Example A.18, with conforming changes as of May 1, 2003.]

[The next page is 20,001.]

¹ Describe any departure from the standard report.

² A different measurement focus and basis of accounting would include changing from a modified accrual basis of accounting to a cash basis, recording depreciation on general fixed assets through the operating statement of a governmental fund type, etc.

AAM TOPICAL INDEX

References are to section and paragraph numbers.

[Reserved.]

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