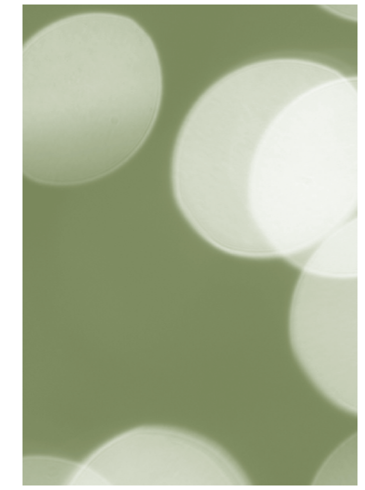
AICPA audit and accounting manual as of June 1, 2008 : nonauthoritative technical practice aid

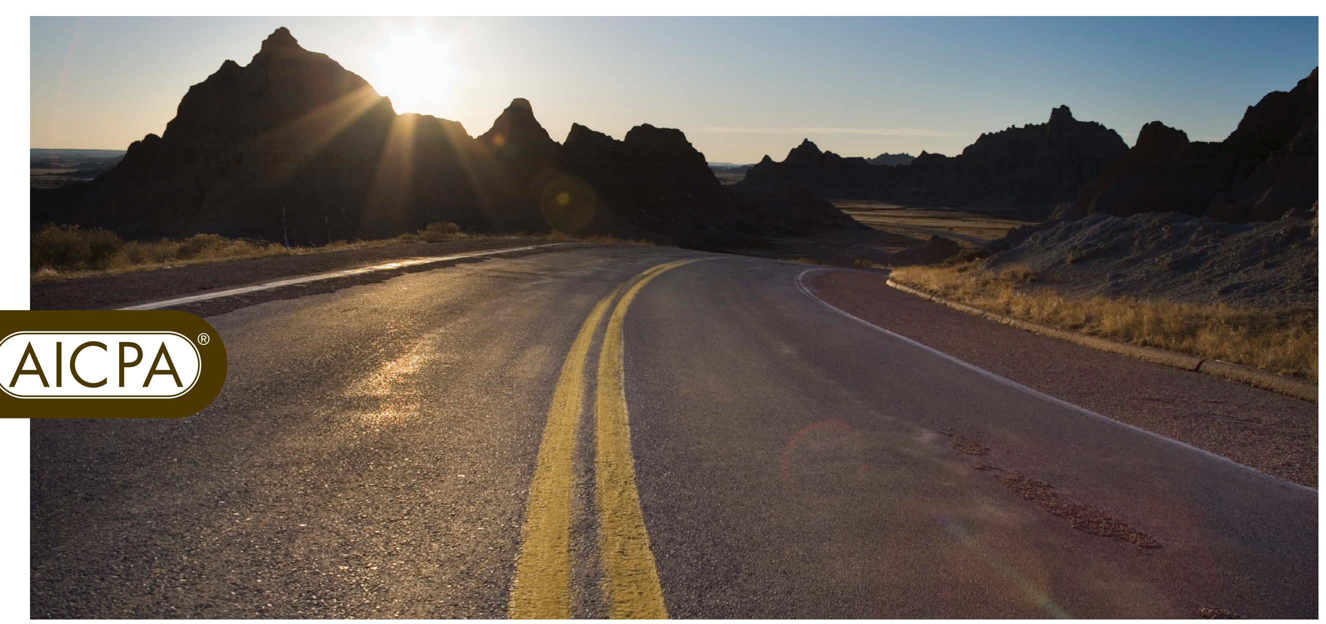
American Institute of Certified Public Accountants (AICPA)



NONAUTHORITATIVE PRACTICE AID

AICPA Audit & Accounting Manual

As of June 1, 2008



AICPA®

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA Audit and Accounting Manual

As of June 1, 2008

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NONAUTHORITATIVE PRACTICE AID

AICPA Audit & Accounting Manual

AS OF JUNE 1, 2008

American Institute of Certified Public Accountants

AICPA®

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HOW *AUDIT AND ACCOUNTING MANUAL* IS ORGANIZED

Updated as of June 1, 2008, this edition has been substantially revised to:

- Conform to the requirements of the risk assessment standards (Statement on Auditing Standards [SAS] Nos. 104–111) including understanding the entity and its environment, including its internal control; assessing the risks of material misstatement; audit risk and materiality; and designing and performing further audit procedures that are responsive to the assessed risks
- Reflect the Defining Professional Requirements standards (SAS No. 102, Statement on Standards for Attestation Engagements [SSAE] No. 13, and Statement on Standards for Accounting and Review Services [SSARS] No. 16)
- Provide additional guidance on the auditor's responsibilities as set forth in SAS Nos. 112–114, including identifying and reporting internal control deficiencies, understanding the link between the auditor's consideration of fraud and the auditor's assessment of risk, dating of the management representation letter, and the auditor's communications with those charged with governance
- Reflect the new requirements of SSARS No. 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services*, which eliminates certain references to the auditing literature from the SSARSs and incorporates, as appropriate, guidance similar to that originally referenced into the compilation and review literature
- 2007/2008 and 2008 Alerts [AAM section 8000]

Scope of *Audit and Accounting Manual*

This Publication 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.

Arrangement of Material in *Audit and Accounting Manual*. . .

The contents of this volume are arranged as follows:

Introduction

Compilation and Review

Engagement Planning and Administration

Internal Control

Designing and Performing Further Audit Procedures

Audit Documentation

Correspondence, Confirmations, and Representations

Alerts

Accountants' Reports

Quality Control

Description of Content . . .

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

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

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

[*The next page is 1001.*]

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 AICPA 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 practitioners apply. 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 This manual is intended to be used in connection with engagements of nonpublic entities and is not intended to be used in connection with audits of public entities that are required to be audited under standards set by the Public Company Accounting Oversight Board.

.03 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* to help users locate those authoritative pronouncements.

.04 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.

.05 Explanation of References:

ACC =	Reference to section number in Accounting Statements of Position in AICPA *Technical Practice Aids*
APB =	AICPA Accounting Principles Board Opinion
AR =	Reference to section number in AICPA *Professional Standards* (vol. 2) for Statements on Standards for Accounting and Review Services
AT =	Reference to section number in AICPA *Professional Standards* (vol. 1) for Statements on Standards for Attestation Engagements
AU =	Reference to section number in AICPA *Professional Standards* (vol. 1) for Statements on Auditing Standards
AUD =	Reference to section number in the Auditing and Attestation Statements of Position in AICPA *Technical Practice Aids*
EITF =	Emerging Issues Task Force consensus
FIN =	Financial Accounting Standards Board (FASB) Interpretation
FSP =	FASB Staff Position
PB =	Accounting Standards Executive Committee Practice Bulletin

(continued)

QC =	Reference to section number in AICPA *Professional Standards* (vol. 2) for Statements on Quality Control Standards
SAS =	AICPA Statement on Auditing 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

.06 The manual is expected to be updated periodically. Changes will likely 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
American Institute of Certified Public Accountants
220 Leigh Farm Road
Durham, NC 27707-8110

[*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, and is not intended to be used in connection with the audits of entities that are required to be audited under standards set by the Public Company Accounting Oversight Board.* The AAM is comprised of the following sections:

Section No.	*Section Name*
2000	Compilation and Review
3000	Engagement Planning and Administration
4000	Internal Control
5000	Designing and Performing Further Audit Procedures
6000	Audit Documentation
7000	Correspondence, Confirmations, and Representations
8000	Alerts
9000	Accountants' Reports
10,000	Quality Control

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. AAM section 10,000, *Quality Control*, 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.

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

c. AAM section 4000, *Internal Control*, conforms to the *Internal Control—Integrated Framework,* published by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report) and AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1). This section provides guidance in evaluating internal control by utilizing checklists, questionnaires, and other generalized aids.

d. AAM section 5000, *Designing and Performing Further Audit Procedures*, explains how the auditor should design and perform tests of controls, substantive procedures, or both, that are responsive to the assessed risks of material misstatement.

e. AAM section 6000, *Audit Documentation*, provides the auditor with a general discussion of the purpose of audit documentation.

f. AAM section 7000, *Correspondence, Confirmations, and Representations*, 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. AAM section 9000, *Accountants' Reports*, 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 a 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. As of the date of this manual, there have been 17 SSARSs issued. Refer to paragraph .10 of AAM section 2100, *Introduction*, for a complete list of the SSARSs that have been codified in the AICPA's *Professional Standards*.

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

a. AAM section 2200, *Engagement Planning and Administration*, 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. AAM section 2300, *Compilation Engagement*, provides sample procedures for compilation engagements, representation letters, and checklists.

c. AAM section 2400, *Review Engagement*, provides sample procedures for review engagements, representation letters, and checklists.

d. AAM section 2500, *Form and Content of Financial Statements*, provides guidance on the statements, notes, supplementary information, and subsequent discovery of facts.

e. AAM section 2600, *Reporting*, provides guidance on the basic reporting fundamentals for compilation and review engagements.

f. AAM section 2610, *Accountants' Reports on Compilation of Financial Statements of a Nonpublic Entity*, and section 2620, *Accountants' Reports on Review of Financial Statements of a Nonpublic Entity*, include examples of several reports for compilation and review engagements.

g. AAM section 2700, *Special Areas*, section addresses other comprehensive bases of accounting, prescribed forms, and specified elements.

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

- *Correspondence, Confirmations, and Representations* (AAM section 7000)
- *Quality Control* (AAM section 10,000)

Alerts

.10 AAM section 8000, *Alerts*, 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 section is a nonauthoritative other compilation and review publication as described in paragraph .07 of AR section 50. As such, the practice aid has no authoritative status; however, it may help an accountant understand and apply the Statements on Standards for Accounting and Review Services (SSARS).

If an accountant applies the guidance included in an other compilation and review publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the engagement and appropriate. This section has been reviewed by the AICPA Audit and Attest Standards staff and, therefore, is presumed to be 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.

Standards for Accounting and Review Services

.02 In accordance with paragraph .01 of AR section 50, *Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2), an accountant must perform a compilation or review of a nonpublic entity in accordance with SSARS issued by the AICPA. SSARS provide a measure of quality and the objectives to be achieved in both a compilation and review.

.03 The SSARS are issued by ARSC and provide performance and reporting standards for compilations and reviews.

.04 Rule 202, *Compliance With Standards*, of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01), states that an AICPA member who performs compilations or reviews shall comply with standards promulgated by ARSC. The ARSC develops and issues standards in the form of SSARS through a due process that includes deliberations in meetings open to the public, public exposure of proposed SSARS, and a formal vote. The SSARS are codified.

.05 The accountant should have sufficient knowledge of the SSARS to identify those that are applicable to his or her engagement. The nature of the SSARS requires an accountant to exercise professional judgment in applying them. The accountant should be prepared to justify departures from the SSARS.

Interpretative Publications

.06 *Interpretative publications* consist of compilation and review interpretations of the SSARS, appendixes to the SSARS, compilation and review guidance included in AICPA Audit and Accounting Guides, and AICPA Statements of Position to the extent that those statements are applicable to compilation and review engagements. Interpretative publications are not standards for accounting and review services. Interpretative publications are recommendations on the application of the SSARS in specific circumstances, including engagements for entities in specialized industries. An interpretative publication is issued after all

* In February 2008, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), which amends some of the guidance for compilation and review engagements. SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. This manual will be updated for SSARS No. 17 in the next edition.

Due to the issuance of SSARS No. 17, AR sections 100, 9100, 200, 300, 9300, and 400 have been moved to AR sections 100A, 9100A, 200A, 300A, 9300A, and 400A, respectively, of *Professional Standards* until the effective date of SSARS No. 17. This manual references the "A" sections as appropriate because SSARS No. 17 has not been incorporated in this edition.

ARSC members have been provided an opportunity to consider and comment on whether the proposed interpretative publication is consistent with the SSARS.

.07 The accountant should be aware of and consider interpretative publications applicable to his or her compilation or review. If the accountant does not apply the guidance included in an applicable interpretative publication, the accountant should be prepared to explain how he or she complied with the SSARS provisions addressed by such guidance.

Other Compilation and Review Publications

.08 *Other compilation and review publications* include AICPA accounting and review publications not referred to above; AICPA's annual *Compilation and Review Alert*; compilation and review articles in the Journal of Accountancy and other professional journals; compilation and review articles in AICPA's *The CPA Letter*; continuing professional education programs and other instruction materials, textbooks, guide books, compilation and review programs, and checklists; and other compilation and review publications from state CPA societies, other organizations, and individuals.[1] Other compilation and review publications have no authoritative status; however, they may help the accountant understand and apply the SSARS.

.09 If an accountant applies the guidance included in an other compilation and review publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the engagement and appropriate. In determining whether an other compilation and review publication is appropriate, the accountant may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying the SSARS and the degree to which the issuer or author is recognized as an authority in compilation and review matters. Other compilation and review publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are presumed to be appropriate.

Overview of SSARS and Interpretations

.10 ARSC has issued 17 SSARSs, which have been codified in the AICPA's *Professional Standards* literature. They are as follows:

Title	*Summary*	Professional Standards *Reference*
SSARS No. 1, *Compilation and Review of Financial Statements* (December 1978)	Provides guidance to CPAs concerning the standards and procedures applicable to engagements to compile or review financial statements.	AR section 100
SSARS No. 2, *Reporting on Comparative Financial Statements* (October 1979)	Establishes standards for reporting on comparative financial statements of a nonpublic entity (or nonissuer) when financial statements of one or more periods have been compiled or reviewed in accordance with AR section 100.	AR section 200

[1] The accountant is not expected to be aware of the full body of other compilation and review publications.

SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (December 1981)	Provides an alternative form of standard compilation report when a prescribed form or related instructions call for a specific departure from generally accepted accounting principles (GAAP). Also provides additional guidance applicable to reports on financial statements included in prescribed form.	AR section 300
SSARS No. 4, *Communication Between Predecessor and Successor Accountants* (December 1981)	Provides guidance to a successor accountant who decides to communicate with a predecessor accountant.	AR section 400
SSARS No. 5, *Reporting on Compiled Financial Statements* (July 1982; Deleted November 1992 by the issuance of SSARS No. 7)	Deleted by SSARS No. 7, November 1992 because the provisions of SSARS No. 5 have been incorporated into AR sections 100, 200, and 300.	AR section 500
SSARS No. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (September 1986)	Provides an exemption from AR section 100 for personal financial statements that are included in written personal financial plans prepared by an accountant and specifies the form of written report required under the exemption.	AR section 600
SSARS No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992* (November 1992)	Contains a number of technical amendments to various standards. Integrated to amend AR sections 100, 200, 300, and 400 and deleted SSARS No. 5.	Not published as a stand-alone section.
SSARS No. 8, *Amendment to Statement on Standards for Accounting and Review Services No. 1*, Compilation and Review of Financial Statements (October 2000)	Amends AR section 100 to create a management-use-only compilation (and make other changes).	Not published as a stand-alone section.
SSARS No. 9, *Omnibus Statement on Standards for Accounting and Review Services—2002* (November 2002)	Contains a number of technical amendments to AR sections 100 and 400.	Not published as a stand-alone section.
SSARS No. 10, *Performance of Review Engagements* (May 2004)	Amends AR section 100.	Not published as a stand-alone section.
SSARS No. 11, *Standards for Accounting and Review Services* (May 2004)	Establishes a SSARS hierarchy and makes practitioners aware of the appropriate literature and the standing of various publications in the SSARS hierarchy. Also amended AR section 200.	AR section 50
SSARS No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005* (July 2005)	Contains a number of technical amendments and additions to AR sections 100 and 200 and rescinds Interpretation No. 26 of AR section 100 and AR section 9100.100–.103.	Not published as a stand-alone section.

(continued)

SSARS No. 13, *Compilation of Specified Elements, Accounts, or Items of a Financial Statement* (July 2005)	Expands SSARS to apply when an accountant is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement. Rescinds Interpretation No. 8 of AR section 100 at AR section 9100.27–.28.	AR section 110
SSARS No. 14, *Compilation of Pro Forma Financial Information* (July 2005)	Expands SSARS to apply when an accountant is engaged to compile or issue a compilation report on pro forma financial information.	AR section 120
SSARS No. 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services* (July 2007)	Contains a number of technical amendments to AR sections 100, 200, 300, and 400. Rescinds Interpretation No. 4, "Discovery of Information After the Date of the Accountant's Report" of AR section 100 at AR section 9100.13–.15 and Interpretation No. 12, "Reporting on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles" of AR section 100 at AR section 9100.41–.45.	Not published as a stand-alone section.
SSARS No. 16, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services* (December 2007)	Defines the terminology the ARSC will use to describe the degrees of responsibility that the requirements impose on the accountant.	AR section 20
SSARS No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (February 2008)†	Contains a number of technical amendments to AR sections 100, 200, 300, and 400.	Not published as a stand-alone section.

.11 In addition to SSARS Nos. 1–17, interpretations are issued by the ARSC to 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. Interpretations of the SSARS can be found in AR sections 9100, 9200, 9300, 9400, and 9600 of AICPA *Professional Standards*, volume 2.

Determining Applicability of AR section 100A

.12 Paragraph .04 of AR section 100A 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).

† SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. Due to the effective date, SSARS No. 17 has not been incorporated into the text of this edition.

.13 Paragraph .04 of AR section 100A defines a *financial statement* as:

A presentation of financial data, including accompanying notes, derived from 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 an OCBOA. Financial forecasts, projections, and similar presentations, and financial presentations included in tax returns are not financial statements for purposes of this section. The following financial presentations are examples of financial statements and are not meant to be all-inclusive:

Appropriate GAAP financial statement titles include the following:

- 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 (condition)
- Statement of activities
- Summary of operations
- Statement of operations by product lines

Appropriate OCBOA financial statement titles:

- Balance sheet—cash basis
- Statement of assets and liabilities arising from cash transactions
- Statement of assets, liabilities, and stockholders' equity—income tax basis
- Statement of revenue collected and expenses paid
- Statement of revenue and expenses—income tax basis
- Statement of income—statutory basis
- Statement of operations—income tax basis

.14 AR section 100A is applicable whenever an accountant submits unaudited financial statements of a nonpublic entity to a client or third parties. In accordance with paragraph .04 of AR section 100A *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.

.15 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.

.16 Absent either of these actions, the financial statements have not been submitted, and AR section 100A is not applicable.

.17 The term *prepared* is not defined in SSARS. Rather, professional judgment will need to be used to determine if financial statements will be prepared. In making this judgment, the accountant might consider the difference between mere bookkeeping services (for example, making adjustments, corrections, and accruals) and preparation of financial statements. In order to prepare financial statements, the accountant may 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 may wish to establish a firm policy to evaluate how certain accounting services are classified within the firm.

.18 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 (for example, via e-mail) may be carefully considered.

.19 The accountant may wish to address the issue of *submission* 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 shall comply with Rules 201, *General Standards*, and 202, *Compliance With Standards*, respectively, of the AICPA's Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 201 par. .01 and ET sec. 202 par. .01). Rule 201 states that an AICPA member shall 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 states that an AICPA member who performs auditing, review, compilation, management consulting, tax, or other professional services shall 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 all prospective clients, the accountant may want to consider if he or she wishes to be associated with them. Factors such as the ability of the accountant to adequately serve the client, the fee arrangement, and client integrity need to be considered.

.04 The firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. The firm may want to acknowledge that the integrity and reputation of a client's management could reflect on the reliability of the client's accounting records and financial representations and, therefore, on the firm's reputation or involvement in litigation.

.05 Although professional standards do not require consideration of the following elements, the accountant might consider them in determining whether or not to accept a client. Certain of these elements may not be applicable to every engagement. Those elements the accountant might consider include the following:

- Information that might bear on the integrity or competence of management. Is there information that gives reason to doubt the integrity or competence of management?
- Past experience with management. Have past experiences on other engagements been positive?
- Independence and objectivity considerations.
- Communication with predecessor accountants or auditors.

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* In February 2008, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), which amends some of the guidance for compilation and review engagements. SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. This manual will be updated for SSARS No. 17 in the next edition.

Due to the issuance of SSARS No. 17, AR sections 100, 9100, 200, 300, 9300, and 400 have been moved to AR sections 100A, 9100A, 200A, 300A, 9300A, and 400A, respectively, of *Professional Standards* until the effective date of SSARS No. 17. This manual references the "A" sections as appropriate because SSARS No. 17 has not been incorporated in this edition.

- Assessment of management's commitment to the appropriate application of generally accepted accounting principles. Inquire of the prospective client about its significant accounting policies.
- Assessment of management's commitment to implementing and maintaining effective internal control. Inquiring of management regarding its commitment to implementing and maintaining effective internal control including antifraud programs and controls and inquiring about the entity's control environment, risk assessment process, information and communications systems relevant to financial reporting, and control and monitoring activities that are in place, and any changes that management believes can be made to enhance the effectiveness of the entity's internal control.
- Assessment of the entity's financial viability.
- Inquiry of third parties.
- Other considerations. The following listing of other considerations is not intended to be all inclusive, and the accountant may wish to consider whether other conditions are present that may create significantly increased risk, and carefully assess those conditions that are identified.
  - Restrictions on scope of services
  - Entities under common control
  - One-time engagements
  - Business and industry environment

.06 As part of the client acceptance procedures, a firm may want to consider its ability to provide professional services, with reference to industry expertise, size of engagement, and personnel available to staff the engagement.

.07 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, Moody's, 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).

.08 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 paragraph .70.

Documentation

.09 Whether or not an engagement is accepted or a professional relationship continued, the firm may document its consideration of the elements of the acceptance and continuance process. If the prospective client becomes or is continued as an attest client of the firm, the firm will typically comply with its document retention policies regarding the client acceptance or continuance consideration. The documentation with respect to prospective clients not accepted need only be retained for purposes of review by the appropriate level of firm management.

Client Needs

.10 Because 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, the accountant may wish to discuss the benefits and cost considerations with the client. In addition, when helping the client decide what level of service is appropriate, the accountant may wish to give special consideration to the issues of independence and the requests of bankers and other creditors on the client.

.11 Several issues for the accountant and client to consider in determining the best type of engagement include the following:

- *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 accountants 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.

.12 If the client does not need audited financial statements, the client 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 compilation[2] (the minimum level of service required if third parties will use the financial statements)
- A management-use-only compilation[3] (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

.13 Paragraph .04 of AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), 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.

.14 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.

.15 There are two types of compilations:

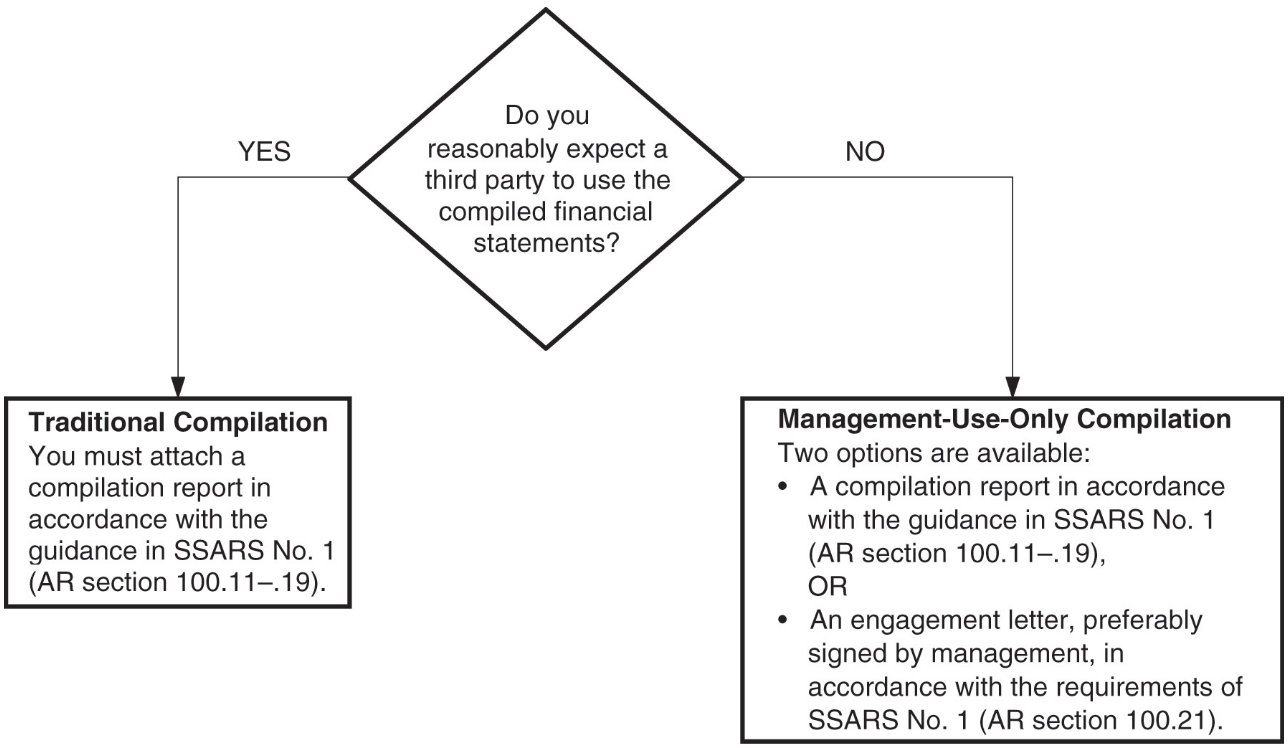
- *A compilation with a report.* Compiled financial statements should be accompanied by a report when the accountant has been engaged to compile and report on the financial statements or when the accountant reasonably expects that the financial statements may be used by a third party. This type of engagement might be referred to as a *traditional compilation.*

[1] See paragraph .15 for more information about types of compilations.
[2] See paragraph .15 for more information about types of compilations.
[3] See paragraph .15 for more information about types of compilations.

- *A compilation without a report*. This 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.*

.16 In either case, the engagement is a compilation, and the accountant must consider the performance requirements of AR section 100A. The difference between the two options lies in the form of communication used in the engagement. See exhibit 2200-1.

Exhibit 2200-1—Communication Options in Compilation Engagements



.17 Though not required by professional standards, the accountant 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.

.18 If the client does not need compiled financial statements (taking into account the needs of the client and other users), the client may, instead, choose to have the accountant 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 may include the following:

- 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

.19 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 paragraph .74.

Independence Issues

.20 If an accountant is not independent, he or she can only perform a compilation service (with report modification). If the client needs reviewed or audited financial statements, the nonindependent CPA may refer the client to another CPA. The primary rules governing independence are found in the *Independence* section of the AICPA Code of Professional Conduct. The independence standards are contained in Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .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.*

.21 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.

.22 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.

.23 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.

.24 On February 28, 2007, the AICPA's Professional Ethics Committee issued a revision to Interpretation No. 101-3, "Performance of nonattest services," of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05), which applies to AICPA members. The revised ethics interpretation modifies the independence requirements of the forensic accounting services provisions and tax provisions and makes them more restrictive starting February 28, 2007.

.25 Ethics Interpretation No. 101-3 states that a member who performs attest services should not perform management functions or make management decisions for an attest client. (However, the member may provide advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions.) If a member is engaged to perform nonattest services, the client must agree to perform the following functions in connection with the engagement:

- Make all management decisions and perform all management functions
- Designate an individual who possesses suitable skill, knowledge, and experience, preferably within senior management, to oversee the services
- Evaluate the adequacy and results of the services performed
- Accept responsibility for the results of the services

.26 The member should be satisfied that the client will be able to meet all these criteria and to make an informed judgment on the results of the member's nonattest services. Assessing the competency of the client's designated employee is a matter of professional judgment. The member should be satisfied that the employee understands the services to be performed sufficiently to oversee them. In cases where the client is unable or unwilling to assume these responsibilities (for example, the client does not have an individual with the necessary competence to oversee the nonattest services provided, or is unwilling to perform such functions due to lack of time or desire), the member's provision of nonattest services would impair independence. Before performing nonattest services, the member should establish and document in writing the client's acceptance of its responsibilities, as well as the objectives of the nonattest engagement, services to be performed, member's responsibilities, and any limitations of the engagement. Code of Professional Conduct ET section 101 provides examples of nonattest services and whether performance of those services would impair independence.

.27 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

.28 Paragraph .05 of AR section 100A 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 paragraphs .22–.23 of AR section 100A.)

Establishing an Understanding With the Client

.29 As noted in the previous paragraph, paragraph .05 of AR section 100A states the CPA should establish an understanding with the client. This understanding should include the following:

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, of any evidence or information that comes to the accountant's attention during the performance of compilation or review procedures, that fraud or an illegal act may have occurred.[4] The accountant need not report any matters regarding illegal acts that may have occurred that are clearly inconsequential and may reach agreement in advance with the entity on the nature of any such matters to be communicated.

.30 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 .23 of AR section 100A:

- 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.

.31 According to paragraph .23 of AR section 100A, the documentation of understanding should also address the following additional matters, if applicable:

- Material departures from generally accepted accounting principles (GAAP) or an other comprehensive bases of accounting (OCBOA) may exist, and the effects of those departures, if any, may not be disclosed.

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[4] Whether an act is, in fact, fraudulent or illegal is a determination that is normally beyond the accountant's professional competence. An accountant, in reporting on financial statements, presents himself or herself as one who is proficient in accounting and compilation or review services. The accountant's training, experience, and understanding of the client and its industry may provide a basis for recognition that some client acts coming to his or her attention may be fraudulent or illegal. However, the determination as to whether a particular act is fraudulent or illegal would generally be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

- 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.

.32 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 the following 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 obligations.

What to Include in an Engagement Letter

.33 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 nonpayment
- 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

.34 If the accountant encounters a situation in which the 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.

.35 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 may prepare a memorandum for the working papers describing the understanding with the client.

.36 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 is typically included in the working papers.

Engagement Letters for Monthly, Quarterly, or Comparative Statements

.37 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 (for example, compilation, review, consulting, bookkeeping, and tax services). However, the accountant may want to be cautious when addressing multiple levels of service (for example, compilation and review) in one engagement letter because this can be confusing to the client.

Minimizing Liability to Third Parties

.38 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.

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

.40 Illustrative engagement letters for compilation engagements are presented in paragraphs .71–.72.

Practice Tip

The accountant may want to be cautious when 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. If the client needs 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 the accountant on the engagement. The accountant may also make sure that a final engagement letter is always issued in such circumstances.

Change in Engagement Level of Service

.41 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

.42 AR section 100A does not specifically address step-ups. Generally, step-ups pose no issues of great concern. The CPA might

- 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.

.43 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 AR section 100A. The accountant may do this even if he or she has previously compiled the financial statements for management's use only.

Practice Tip

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 (compiled, reviewed, or audited), that service can be provided separately.

Step-Downs and Changes in Service

Step-Down From Audit to Review or Compilation

.44 Paragraphs .73–.78 of AR section 100A discuss 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. They are as follows:

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 may want to consider explaining 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.
- Paragraph .76 of AR section 100A describes the following two circumstances that would preclude a step-down:
  - The accountant has been prohibited from corresponding with the entity's legal counsel.
  - The management or owner has refused to sign a client representation letter.

Step-Down From Review to Compilation

.45 Paragraph .73 of AR section 100A lists the following 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 may want to consider explaining 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

.46 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

.47 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

.48 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

.49 AR section 400A, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*, vol. 2), establishes guidance for communication between predecessor and successor accountants. Unlike AU section 315, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1), which requires such communication between predecessor and successor auditors, AR section 400A 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 and its management and principals 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.

.50 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.

.51 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 (see paragraph .04 of AR section 400A).

Inquiries Regarding Acceptance of the Engagement

.52 According to paragraph .05 of AR section 400A, 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 may include the following:

- 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

.53 Paragraph .06 of AR section 400A states that the predecessor accountant, when authorized by the client, should 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 following paragraph.) The successor accountant should consider the reasons and consider the implications of such a response in connection with acceptance of the engagement.

.54 Paragraph .08 of AR section 400A states that the successor accountant may wish to review the predecessor's working papers. In these circumstances, the successor accountant should request the client to authorize the predecessor accountant to allow access. Ordinarily, the predecessor accountant should make available certain working 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 working papers. Unpaid fees constitute a valid business reason to deny access to the predecessor accountant's working papers. 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 AR section 400A 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 working papers available to more than one prospective successor accountant.

Materially Misleading Financial Statements

.55 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. Paragraph .64 of AR section 100A provides guidance to the predecessor accountant in determining an appropriate course of action. 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

.56 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. Because of the variety of conditions that might be encountered, some of the procedures discussed subsequently are necessarily set out only in general terms; the specific actions to be taken in a particular case may vary with the circumstances. The accountant would be well advised to consult with his or her legal counsel and insurance provider when he or she encounters the circumstances to which this section may apply because of legal implications that may be involved in actions contemplated herein.

.57 As stated in paragraph .65 of AR section 100A, after the date of the accountant's compilation or review report, the accountant has no obligation to perform other compilation or review procedures with respect to the financial statements, unless new information comes to his or her attention. However, when the accountant becomes aware of information that relates to financial statements previously reported on by him or her, but that was not known to the accountant at the date of the report, and that is of such a nature and from such a source that the accountant would have investigated it had it come to his or her attention during the course of the compilation or review, the accountant should, as soon as practicable, undertake to determine whether the information is reliable and whether the facts existed at the date of the report. In this connection, the accountant should discuss the matter with his or her client at whatever management levels the accountant deems appropriate, including the board of directors, and request cooperation in whatever investigation may be necessary. If the nature and effect of the matter are such that (*a*) the accountant's report or the financial statements would have been affected if the information had been known to the accountant at the accountant's compilation or review report date and had not been reflected in the financial statements and (*b*) the accountant believes that there are persons currently using or likely to use the financial statements who would attach importance to the information, the accountant should

- in a compilation engagement, obtain additional or revised information.

- in a review engagement, perform the additional procedures deemed necessary to achieve limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with generally accepted accounting principles.

With respect to (*b*), consideration should be given, among other things, to the time elapsed since the financial statements were issued.

.58 When the accountant has concluded, after considering (*a*) and (*b*) in the preceding paragraph as appropriate, that action should be taken to prevent further use of the accountant's report or the financial statements, the accountant should advise his or her client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently using or who are likely to use the financial statements. When the client undertakes to make appropriate disclosure, the method used and the disclosure made will depend on the circumstances.

a. If the effect on the accountant's report or the financial statements of the subsequently discovered information can promptly be determined, disclosure should consist of issuing, as soon as practicable, revised financial statements and, where applicable, the accountant's report. The reasons for the revision usually should be described in a note to the financial statements and, where applicable, referred to in the accountant's report. Generally, only the most recently issued, compiled, or reviewed financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.[5]

b. When issuance of financial statements for a subsequent period is imminent, so that disclosure is not delayed, appropriate disclosure of the revision can be made in such statements instead of reissuing the earlier statements pursuant to subparagraph (*a*).[6]

c. When the effect on the financial statements of the subsequently discovered information cannot be promptly determined, the issuance of revised financial statements would necessarily be delayed. In this circumstance, when it appears that the information will require a revision of the statements, appropriate disclosure would consist of notification by the client to persons who are known to be using or who are likely to use the financial statements that they should not be used, and that revised financial statements will be issued and, where applicable, the accountant's report will be issued as soon as practicable.

.59 The accountant should take whatever steps he or she deems necessary to satisfy himself or herself that the client has made the disclosures specified in paragraph .58 of this section.

.60 If the client refuses to make the disclosures specified in paragraph .58 of this section, the accountant should notify the appropriate personnel at the highest levels within the entity, such as the manager (owner) or the board of directors, of such refusal and of the fact that, in the absence of disclosure by the client, the accountant will take steps as subsequently outlined to prevent further use of the financial statements and, if applicable, the accountant's report. The steps that can appropriately be taken will depend upon the degree of certainty of the accountant's knowledge that there are persons who are currently using or who will use the financial statements and, if applicable, the accountant's report, and who would attach importance to the information, and the accountant's ability as a practical matter to communicate with them. Unless the accountant's attorney recommends a different course of action, the accountant should take the following steps to the extent applicable:

a. Notification to the client that the accountant's report must no longer be associated with the financial statements.

b. Notification to the regulatory agencies having jurisdiction over the client that the accountant's report should no longer be used.

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[5] See paragraphs 26–27 of Accounting Principles Board (APB) Opinion No. 9, *Reporting the Results of Operations*, and paragraphs 25–26 of Financial Accounting Standards Board (FASB) Statement No. 154, *Accounting Changes and Error Corrections*, regarding disclosure of adjustments applicable to prior periods.

[6] See paragraphs 26–27 of APB Opinion No. 9 and paragraphs 25–26 of FASB Statement No. 154 regarding disclosure of adjustments applicable to prior periods.

c. Notification to each person known to the accountant to be using the financial statements that the financial statements and the accountant's report should no longer be used. In many instances, it will not be practicable for the accountant to give appropriate individual notification to stakeholders whose identities ordinarily are unknown to him or her; notification to a regulatory agency having jurisdiction over the client will usually be the only practicable way for the accountant to provide appropriate disclosure. Such notification should be accompanied by a request that the agency take whatever steps it may deem appropriate to accomplish the necessary disclosure.

Although a compilation report does not express any form of assurance on the financial statements, it would seldom be appropriate for an accountant to conclude, simply because his or her responsibilities were limited to a compilation service, that notification of third party users in the absence of notification by the client is not required when the accountant knows that the financial statements should be revised.

.61 The following guidelines should govern the content of any disclosure made by the accountant in accordance with paragraph .60 of this section to persons other than his or her client:

a. The disclosure should include a description of the nature of the subsequently acquired information and its effect on the financial statements.

b. The information disclosed should be as precise and factual as possible and should not go beyond that which is reasonably necessary to accomplish the purpose mentioned in the preceding subparagraph (*a*). Comments concerning the conduct or motives of any person should be avoided.

If the client has not cooperated, the accountant's disclosure need not detail the specific information, but can merely indicate that information has come to his or her attention which the client has not cooperated in attempting to substantiate and that, if the information is true, the accountant believes that the compilation or review report must no longer be used or associated with the financial statements. No such disclosure should be made unless the accountant believes that the financial statements are likely to be misleading and that the accountant's compilation or review report should not be used.

Management-Use-Only Financial Statements Distributed to Third Parties

.62 Paragraph .25 of AR section 100A 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.

.63 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 discuss with the client 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.

.64 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.

.65 Some accountants 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 will likely be very low.

Practice Tip

Notification of third parties would involve legal matters beyond the scope of this manual. Therefore, the accountant might want to 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 paragraph .71).

When to Withdraw From an Engagement

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

- He or she determines that he or she 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.

Key Question and Answer Guidance

.67 The AICPA Practice Aid *Compilation and Review Engagements—Essential Questions and Answers* (product no. 006622) is an extensive compendium of questions and answers about compilation and review services. The content was assembled by CPAs with extensive knowledge and experience in the compilation and review arena. The questions and answers were developed from inquiries received by the AICPA Accounting and Auditing Technical Hotline, the AICPA *Technical Practice Aids*, the AICPA Ethics division, and from the collective knowledge and experience of the authors.

.68 Answering specific questions about compilations and reviews, this practice aid covers many topics including the following:

- Accounting principles
- Engagement administration
- Prescribed forms
- Supplementary information
- Fraud and illegal acts

- Interim financial statements
- Financial statements prepared on an other comprehensive basis of accounting
- Personal financial statements

.69 Moreover, the practice aid provides an overview of the standards and guidance associated with compilations and reviews. Developed in an easy-to-read format, *Compilation and Review Engagements—Essential Questions and Answers* is available by calling the AICPA at 888-777-7077 or going online at www.cpa2biz.com.

.70

Client Acceptance and Continuance Form—Part I
Client: ______________________________   **Financial Statement Date:** ______________________________

INSTRUCTIONS:

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

Part II: Part II is typically 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 (for example, corporation, proprietorship, partnership, or S corporation):

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: ______________________

   ____

   ____

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

____

____

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

8. Describe the services our firm is to provide: ______________________________

____

____

	How Often?			Report Deadlines
Service	Monthly	Quarterly	Annually	

<u>Other Services:</u>

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:

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:

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)?	☐	☐
2.	Are we aware of any significant disagreements between management (owners) and the predecessor accountant?	☐	☐
3.	Does there appear to be any potential fee collection problems?	☐	☐
4.	Are the client's needs beyond our capabilities or staffing abilities?	☐	☐
5.	Are we aware of any independence problems that may affect our ability to meet the client's needs?	☐	☐
6.	Are there high-risk factors related to the engagement that may affect our decision to accept the client?	☐	☐
7.	Is there a potential problem with management (owners) not fully understanding the limitations of the services to be provided (for example, management's expectation that we will be responsible for the detection of fraud)?	☐	☐
8.	Is the required staffing or expertise necessary for this engagement beyond our capabilities?	☐	☐

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

Acceptance Decision:

Yes ____ No ____

Engagement Partner: ____ Date: ____________

Concurring Partner: ____ Date: ____________

.71 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:

> I (We) will compile, from information you provide, the [*monthly, quarterly, or other frequency*] financial statements of Gowers Drug Stores for the year 20XX.
>
> I (We) will compile the financial statements 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) 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*]

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, of any evidence or information that comes to my (our) attention during the performance of compilation procedures, that fraud may have occurred. In addition, I (we) will report to you any evidence or information that comes to my (our) attention during the performance of my (our) compilation procedures regarding illegal acts that may have occurred unless they are clearly inconsequential.

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

As part of my (our) engagement, I (we) will also (list any nonattest services to be provided, if applicable, such as income tax preparation and bookkeeping services).

You are responsible for

a. making all management decisions and performing all management functions;

b. designating an individual who possesses suitable skill, knowledge, and experience, preferably within senior management, to oversee the services;

[†] In February 2008, the ARSC issued SSARS No. 17, which, among other things, amends appendix D of AR section 100A, from which this illustrative engagement letter is derived. SSARS No. 17 is effective for periods ending on or after December 15, 2008, with early application permitted. This letter will be updated for SSARS No. 17 in the next edition.

c. evaluating the adequacy and results of the services performed;

d. accepting responsibility for the results of the services; and

e. establishing and maintaining internal controls, including monitoring ongoing activities.

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*]

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.[7]

Sincerely yours,

____

[*Signature of accountant*]

Accepted and agreed to:

Gowers Drug Stores

____

Title

____

Date

[7] 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 . . ."

.72 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:

> 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 compile the financial statements and issue an accountant's report thereon in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. 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.

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, and of any evidence or information that comes to our attention during the performance of my (our) compilation procedures, that fraud may have occurred. In addition, I (we) will report to you any evidence or information that comes to my (our) attention during the performance of my (our) compilation procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

As part of my (our) engagement, I (we) will also (list any nonattest services to be performed, if applicable, such as income tax preparation and bookkeeping services).

You are responsible for

a. making all management decisions and performing all management functions;

b. designating an individual who possesses suitable skill, knowledge, and experience, preferably within senior management, to oversee the services;

c. evaluating the adequacy and results of the services performed;

d. accepting responsibility for the results of the services; and

e. establishing and maintaining internal controls, including monitoring ongoing activities.

If, for any reason, I (we) am (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.

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

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

[‡] In February 2008, the ARSC issued SSARS No. 17, which, among other things, amends appendix C of AR section 100A, from which this illustrative engagement letter is derived. SSARS No. 17 is effective for periods ending on or after December 15, 2008, with early application permitted. This letter will be updated for SSARS No. 17 in the next edition.

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).[8]

Sincerely yours,

____
[*Signature of accountant*]

Accepted and agreed to:

Gowers Drug Stores

____
Title

____
Date

[8] 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 . . ."

.73 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:

> 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, and issue an accountant's report thereon in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. 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.
>
> A review consists primarily of inquiries of company personnel and analytical procedures applied to financial data. 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, and of any evidence or information that comes to our attention during the performance of our review procedures, that fraud may have occurred. In addition, I (we) will report to you any evidence or information that comes to my (our) attention during the performance of my (our) review procedures regarding illegal acts that may have occurred, unless they are clearly inconsequential.

As part of my (our) engagement, I (we) will also (list any nonattest services to be provided, if applicable, such as income tax preparation and bookkeeping services).

You are responsible for

a. making all management decisions and performing all management functions;

b. designating an individual who possesses suitable skill, knowledge, and experience, preferably within senior management, to oversee the services;

c. evaluating the adequacy and results of the services performed;

d. accepting responsibility for the results of the services; and

e. establishing and maintaining internal controls, including monitoring ongoing activities.

As part of my (our) review procedures, I (we) will require certain written representations from management about the financial statements and matters related thereto.

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

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

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

[||] In February 2008, the ARSC issued SSARS No. 17, which, among other things, amends appendix E of AR section 100A, from which this illustrative engagement letter is derived. SSARS No. 17 is effective for periods ending on or after December 15, 2008, with early application permitted. This letter will be updated for SSARS No. 17 in the next edition.

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

.74 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. As defined by professional standards, a submission of financial statements occurs when an accountant presents to a client or third parties financial statements that the accountant has prepared either 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.

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 Paragraph .04 of AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), 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 AR section 100A now provides for two types of compilations:

- Compiled financial statements should be accompanied by a report 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, and the accountant must consider the performance requirements in AR section 100A. 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 accountants have suggested that there is no real difference between the traditional compilation and the management-use-only compilation because 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 the following:

- *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.

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* In February 2008, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), which amends some of the guidance for compilation and review engagements. SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. This manual will be updated for SSARS No. 17 in the next edition.

Due to the issuance of SSARS No. 17, AR sections 100, 9100, 200, 300, 9300, and 400 have been moved to AR sections 100A, 9100A, 200A, 300A, 9300A, and 400A, respectively, of *Professional Standards* until the effective date of SSARS No. 17. This manual references the "A" sections as appropriate because SSARS No. 17 has not been incorporated in this edition.

— *Traditional Compilation (Report)*—Paragraphs .51–.52 of AR section 100A 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). The accountant is not required to determine the effects of a departure if management has not done so, provided the accountant states in the report that such determination has not been made.

— *Management-Use-Only Compilation (Engagement Letter)*—Paragraph .23 of AR section 100A states that the accountant should include in the engagement letter a statement that material departures from generally accepted accounting principles (GAAP) or an other comprehensive bases of accounting (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 should 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 paragraph .33 of AAM section 2200, *Engagement Planning and Administration.* It is permissible to issue one engagement letter to cover multiple periods or multiple services, or both. 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 AR section 100A states that in all compilation engagements, the performance standards in paragraph .05 and paragraphs .07–.10 of AR section 100A should be followed.

.08 These performance standards consist of the following:

- *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, nonauthoritative 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 because 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 paragraphs .29–.40 of AAM section 2200).
- 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 should comply with the reporting requirements in paragraphs .11–.20 of AR section 100A.

.11 Illustrative reports for compiled financial statements are included in AAM section 2610, *Accountants' Reports on Compilation of Financial Statements of a Nonpublic Entity*.

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 and document that understanding through the use of an engagement letter (See paragraphs .29–.40 of AAM section 2200).

- 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. Paragraph .04 of AR section 100A defines *third parties* as follows:

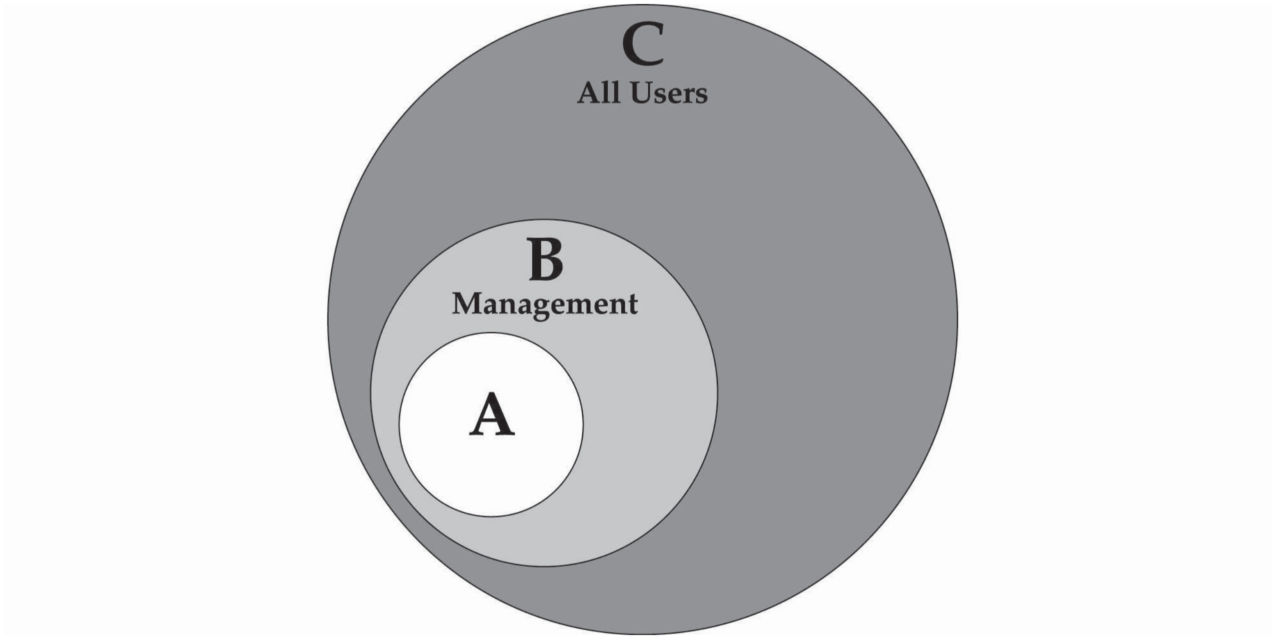
> All parties except for members of management who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.

.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 about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements. In order to not be considered a third party, the person or persons could meet the following 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 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



.16 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.

.17 This definition does not mean that certain members of management have to be thoroughly knowledgeable about technical accounting principles and procedures. Instead, management might 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.

.18 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

.19 Some accountants 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 Statements on Standards for Accounting and Review Services (SSARSs), it is permissible to attach such a letter to management-use-only financial statements. This letter, however, may not contain any language that resembles that found in a traditional compilation report.

Documentation Requirement

.20 AR section 100A does not discuss working 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 in the following list 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

.21 In order to reduce misunderstandings, an accountant might document all client discussions, in person or over the phone. Such documentation could identify all parties to the discussion, what was said, and by whom. Entries could be initiated and dated by the accountant. Also, the accountant may wish to 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, the accountant may wish to send a follow-up letter to the client explaining the substance of the discussions and detailed recommendations.

.22 As a best practice, the accountant may have a policy to never include unsubstantiated subjective statements in a working paper file. If documenting observations regarding questionable client ethics or possible fraud, the accountant may consider listing the objective findings that led to this observation. In addition, the accountant may want to reflect and accurately describe work performed during the engagement on timesheets. Additionally, it is best to 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.

.23 Compilation Engagement Program

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

[1] AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), 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).

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 the following:	
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.	
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.	

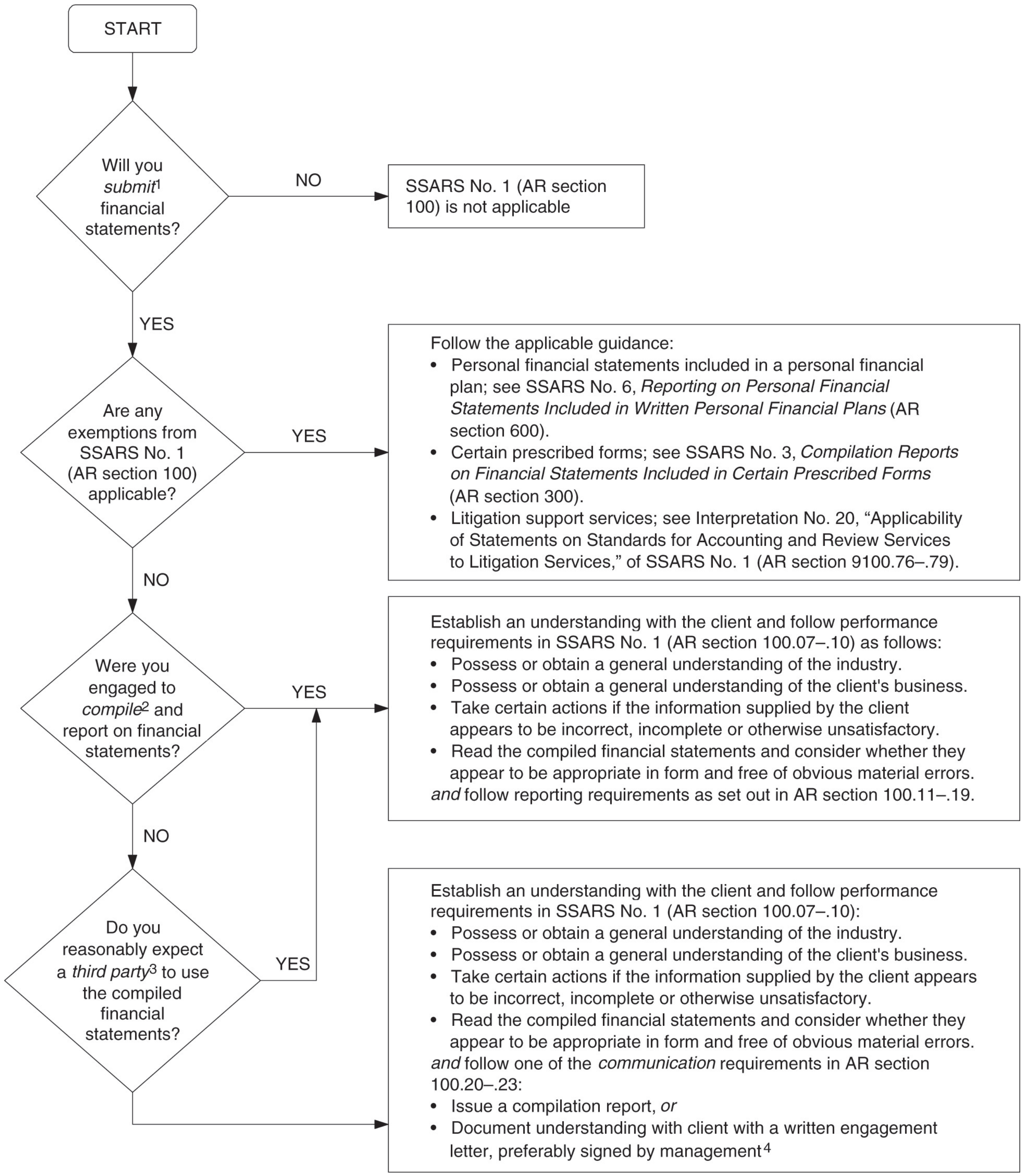
(continued)

Procedure	Completed by or N/A
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 working papers.	
17. Date the report as of the date the compilation was completed.	

Compilation of Financial Statements Flowchart

.24 During the initial development of 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. 100A), the members of the Accounting and Review Services Committee designed a flowchart to help guide their discussion about the proposed changes in AR section 100A. That flowchart, which first appeared in SSARS No. 8, is also currently available in appendix A, "Compilation of Financial Statements," of AR section 100A We are including it here with the addition of explanatory notes following.

Exhibit 2300-2—Compilation of Financial Statements



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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 GAAP or 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

.25 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 working 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, of any evidence or information that comes to my (our) attention during the engagement, that fraud or an illegal act may have occurred, 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 the following:	
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.	

(continued)

Procedure	Completed by or N/A
b. the financial statements are free of obvious mathematical or clerical error.	
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 working papers.	

[*The next page is 2401.*]

AAM Section 2400

Review Engagements[*]

Overview

.01 Paragraph .04 of AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), 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 generally accepted accounting principles (GAAP) or, if applicable, with an other comprehensive bases of accounting (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 and reporting requirements 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 paragraphs .29–.40 of AAM section 2200 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 working papers, as required by paragraphs .38–.40 of AR section 100A.

Knowledge of Accounting Principles and Practices of the Industry

.04 AR section 100A states that the accountant should 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.

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[*] In February 2008, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), which amends some of the guidance for compilation and review engagements. SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. This manual will be updated for SSARS No. 17 in the next edition.

Due to the issuance of SSARS No. 17, AR sections 100, 9100, 200, 300, 9300, and 400 have been moved to AR sections 100A, 9100A, 200A, 300A, 9300A, and 400A, respectively, of *Professional Standards* until the effective date of SSARS No. 17. This manual references the "A" sections as appropriate because SSARS No. 17 has not been incorporated in this edition.

.05 The purpose of having that knowledge in a review is not the same, however, as in a compilation. 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 a 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.

.06 AR section 100A states that the accountant should possess or obtain certain knowledge about the entity whose financial statements are under review. Because 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 the following:

- 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 Paragraph .04 of AR section 100A 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 Because 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 compile the financial statements. Therefore, an accountant will need to consider independence requirements in relation to conducting a review in this circumstance. In making a judgment about whether he or she is independent, the accountant must comply with standards set forth in the AICPA Code of Professional Conduct.

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

Inquiries and Analytical Procedures

.12 Procedures for conducting a review of financial statements generally are limited to analytical procedures and inquiries. The accountant performs these procedures to obtain a basis for communicating whether he or she is aware of any material modifications that should be made to the financial statements for them to be in conformity with generally accepted accounting principles. The specific inquiries made and the analytical and other procedures performed should be tailored to the engagement based on the accountant's knowledge of the entity's business. For example, if the accountant becomes aware of a significant change in the entity's operations, the accountant may consider making additional inquiries, employing additional analytical procedures, or both. Professional literature does not indicate how many procedures have to 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.

Analytical Procedures

.13 Paragraph .31 of AR section 100A states that the accountant should apply analytical procedures to the financial statements to identify and provide a basis for inquiry about the relationships and individual items that appear to be unusual and that may indicate a material misstatement. Analytical procedures should include the following:

- Developing expectations by identifying and using plausible relationships that are reasonably expected to exist based on the accountant's understanding of the entity and the industry in which the entity operates
- Comparing recorded amounts, or ratios developed from recorded amounts, to expectations developed by the accountant

.14 Appendix I of AR section 100A contains examples of analytical procedures an accountant may consider performing when conducting a review of financial statements.

.15 A list of examples of analytical procedures for a review engagement is included in paragraph .48.

.16 Expectations developed by the accountant in performing analytical procedures in connection with a review of financial statements ordinarily are less encompassing than those developed in an audit. Also in a review, the accountant ordinarily is not required to corroborate management's responses with other evidence. However, the accountant should consider the reasonableness and consistency of management's responses in light of the results of other review procedures and the accountant's knowledge of the entity's business and the industry in which it operates.

.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 AR section 100A 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.

Inquiries and Other Review Procedures

.20 The following are inquiries the accountant should consider making and other review procedures the accountant should consider performing when conducting a review of financial statements:

a. Inquiries to members of management who have responsibility for financial and accounting matters concerning (see appendix B of AR section 100A):

(1) Whether the financial statements have been prepared in conformity with generally accepted accounting principles consistently applied

(2) The entity's accounting principles and practices and the methods followed in applying them and procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements

(3) Unusual or complex situations that may have an effect on the financial statements

(4) Significant transactions occurring or recognized near the end of the reporting period

(5) The status of uncorrected misstatements identified during the previous engagement

(6) Questions that have arisen in the course of applying the review procedures

(7) Events subsequent to the date of the financial statements that could have a material effect on the financial statements

(8) Their knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, for example, communications received from employees, former employees, or others

(9) Significant journal entries and other adjustments

(10) Communications from regulatory agencies

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

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

d. Obtaining reports from other accountants, if any, who have been engaged to audit or review the financial statements of significant components of the reporting entity, its subsidiaries, and other investees[1]

.21 Appendix B of AR section 100A contains illustrative inquiries for a review engagement. However, these illustrative inquires 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.

[1] The financial statements of the reporting entity ordinarily include an accounting for all significant components, such as unconsolidated subsidiaries and investees. If other accountants are engaged to audit or review the financial statements of such components, the accountant will require reports from the other accountants as a basis, in part, for the accountant's review report with respect to the review of the financial statements of the reporting entity. The accountant may decide to make reference to the work of other accountants in the accountant's review report on the financial statements. If such reference is made, the report should indicate the magnitude of the portion of the financial statements audited or reviewed by the other accountants.

.22 A list of illustrative inquiries for a review engagement is included in paragraph .53.

.23 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. AR section 100A does not specify how many procedures have to be performed in order to express the limited assurance. The extent and type of procedures performed is a matter of professional judgment.

.24 Paragraph .37 of AR section 100A 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

.25 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, paragraph .37 of AR section 100A 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 reviewed financial statements.

.26 This allows the accountant to modify his or her inquiries and analytical procedures based on knowledge acquired in the performance of other services. Although AR section 100A 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.

.27 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

.28 When results of analytical procedures are unfavorable (that is, the accountant believes that fluctuations from expected amounts are significant), paragraph .27 of AR section 100A states that the accountant should apply additional procedures deemed necessary to 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.

.29 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. AR section 100A does not specify how many procedures have to be performed in order to express the limited assurance. The extent and type of procedures performed is a matter of professional judgment.

.30 An illustrative ratio analysis worksheet is included in paragraph .54, and an illustrative analytical procedures comparative report is included in paragraph .55.

Awareness Concerning Information Supplied

.31 Paragraph .27 of AR section 100A states that a review does not contemplate various procedures that are ordinarily performed during an audit. However, it goes on to state that "…the accountant may become aware that information coming to his or her attention is incorrect, incomplete, or otherwise unsatisfactory. If any evidence or information comes to the accountant's attention regarding fraud or an illegal act that may have occurred, the accountant should request that management consider the affect of the matter on the financial statements. Additionally, the accountant should consider the affect of the matter on his or her review report. In circumstances where the accountant believes the financial statements are materially misstated, the accountant should perform the additional procedures deemed necessary to achieve limited assurance…"

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

.33 Paragraph .46 of AR section 100A 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

.34 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:[2]

- 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 with GAAP
- Management's belief that the financial statements are fairly presented in conformity with generally accepted accounting principles
- Management's acknowledgement of its responsibility to prevent and detect fraud
- Knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others
- Management's full and truthful response to all inquiries
- Completeness of information
- Information concerning subsequent events

.35 Like the inquiries and analytical procedures in a review engagement, the management representation letter ordinarily 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 (for example, construction contractors, homeowners associa-

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

tions, and not-for-profit organizations). These additional representations may be found in AICPA *Industry Audit and Accounting Guides* which can be obtained by contacting AICPA Service Center Operations at 888-777-7077.

.36 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 because 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.

.37 An illustrative management representation letter is provided in appendix F of AR section 100A and is included in paragraph .51.

.38 There are circumstances in which an accountant should consider obtaining an updating represen tation letter from management (for example, the accountant obtains a management representation letter after completion of inquiry and analytical review procedures but does not issue his or her review report for a significant period of time thereafter, or a material subsequent event occurs after the completion of inquiry and analytical review procedures, including obtaining the original management representation letter, but before the issuance of the report on the reviewed financial statements). In addition, if a predecessor accountant is requested by a former client to reissue his or her report on the financial statements of a prior period, and those financial statements are to be presented on a comparative basis with reviewed financial statements of a subsequent period, the predecessor accountant should obtain an updating representation letter from the management of the former client. The updating management representation letter should state (*a*) whether any information has come to management's attention that would cause management to believe that any of the previous representations should be modified and (*b*) whether any events have occurred subsequent to the balance sheet date of the latest financial statements reported on by the accountant that would require adjustment to or disclosure in those financial statements.

.39 An illustrative updating management representation letter is provided in appendix G of AR section 100A and is included in paragraph .50.

Work Paper Documentation

.40 The accountant should prepare documentation in connection with a review of financial statements, the form and content of which should be designed to meet the circumstances of the particular engagement. Documentation is the principal record of the review procedures performed and the conclusions reached by the accountant in performing the review. However, an accountant would not be precluded from supporting his or her review report by other means in addition to the review documentation. Such other means might include written documentation contained in other engagement (for example, compilation) files or quality control files (for example, consultation files) and in limited situations, oral explanations. Oral explanations should be limited to those situations where the accountant finds it necessary to supplement or clarify information contained in the documentation. Oral explanations should not be the principal support for the work performed or the conclusions reached.

.41 Paragraph .39 of AR section 100A states that it is not possible to specify the form or content of the documentation the accountant should prepare because of the different circumstances in individual engagements. However, the documentation should include any findings or issues that in the accountant's judgment are significant, for example, the results of review procedures that indicate the financial statements could be materially misstated, including actions taken to address such findings, and the basis for the final conclusions reached.

.42 Paragraph .40 of AR section 100A states that the documentation of the inquiry and analytical procedures should include the following:

- The matters covered in the accountant's inquiry procedures
- The analytical procedures performed
- The expectations as discussed in paragraph .31 of AR section 100A, where significant expectations are not otherwise readily determinable from the documentation of the work performed, and factors considered in the development of those expectations
- Results of the comparison of the expectations to the recorded amounts or ratios developed from recorded amounts
- Any additional procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures
- Unusual matters that the accountant considered during the performance of the review procedures, including their disposition
- Communications, whether oral or written, to the appropriate level of management regarding fraud or illegal acts that come to the accountant's attention
- The representation letter

.43 In addition, most accountants include some or all of the following in their working 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
- 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
- Reasons for a step-down from an audit, if applicable

Additional Guidance

.44 For additional guidance, accountants may refer to the AICPA Accounting and Review Services Committee Issue Paper on *Analytical Procedures in a Review Engagement* which is intended to provide accountants with information that may help them understand certain requirements related to the use of analytical procedures in review engagements and how the use of analytical procedures can be documented in those engagements.

.45 Accountants may also refer to the AICPA Practice Aid *Review Engagements—New and Expanded Guidance on Analytical Procedures and Inquiries and Other Procedures* (product number 006618). The practice aid clarifies certain existing Statements on Standards for Accounting and Review Services (SSARS), suggests ways of implementing existing and new standards in special circumstances, and provides practical guidance to help implement the changes to AR section 100A.

.46 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. Apply analytical procedures to the financial statements to identify and provide a basis for inquiry about relationships and individual items that appear to be unusual and that may indicate a material misstatement. Consider performing the analytical procedures described in paragraph .48 of AAM section 2400.	
8. Inquire of members of management having responsibility for financial and accounting matters concerning the following:	
a. Whether the financial statements have been prepared in conformity with GAAP or OCBOA consistently applied.	
b. The entity's accounting principles and practices and the methods followed in applying them and procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements.	
c. Unusual or complex situations that may have an effect on the financial statements.	
d. Significant transactions occurring or recognized near the end of the reporting period.	
e. The status of uncorrected misstatements identified during the previous engagement.	
f. Questions that have arisen in the course of applying the review procedures.	
g. Events subsequent to the date of the financial statements that could have a material effect on the financial statements.	

(continued)

Procedure	Completed by or N/A
h. Their knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, for example, communications received from employees, former employees, or others.	
i. Significant journal entries and other adjustments.	
j. Communications from regulatory agencies.	
9. Make inquiries concerning actions taken at meetings of shareholders, board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements.	
10. Read the financial statements to consider whether, on the basis of information coming to the accountant's attention:	
a. the financial statements appear to conform with GAAP or an OCBOA.	
b. financial statements prepared in accordance with an OCBOA present proper OCBOA titles and disclose the basis of accounting in the notes or in the review report.	
c. the financial statements are appropriate in form.	
d. the financial statements are free from obvious mathematical or clerical error.	
11. Obtain reports from other accountants, if any, who have been engaged to audit or review the financial statements of significant components of the reporting entity, its subsidiaries, and other investees.	
12. If there is any indication that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory, obtain additional or revised information.	
13. Draft the accountant's report.	
14. 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.	
15. Obtain a representation letter.	
16. If supplementary data accompanies the financial statements, modify the report in accordance with paragraph .70 of AR section 100A.	
17. Include a reference to the report on each page of the financial statements and supplementary data.	
18. Document the following:	
a. The matters covered in the accountant's inquiry procedures	

Procedure	Completed by or N/A
b. The analytical procedures performed	
c. The expectations as discussed in paragraph .31 of AR section 100A, where significant expectations are not otherwise readily determinable from the documentation of the work performed and factors considered in the development of those expectations	
d. Results of the comparison of the expectations to the recorded amounts or ratios developed from recorded amounts	
e. Any additional procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures	
f. Findings, issues, and unusual matters that the accountant considered during the performance of the review procedures, including actions taken to address such matters, their disposition, and the final conclusions reached	
g. Communications, whether oral or written, to the appropriate level of management regarding fraud or illegal acts that come to the accountant's attention	
19. Determine that all required forms and checklists have been completed.	
20. 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 working papers.	
21. Date the report as of the date the review was completed.	

Analytical Procedures the Accountant May Consider Performing When Conducting a Review of Financial Statements

.47 Analytical procedures are designed to identify relationships and individual items that appear to be unusual and that may reflect a material misstatement of the financial statements. The analytical procedures performed in a review of financial statements are a matter of the accountant's professional judgment. In determining the appropriate analytical procedures, an accountant may consider (*a*) the nature and materiality of the items reflected in the financial statements, (*b*) the likelihood of a misstatement in the financial statements, (*c*) knowledge obtained during current and previous engagements, (*d*) the stated qualifications of the entity's accounting personnel, (*e*) the extent to which a particular item is affected by management's judgment, and (*f*) inadequacies in the entity's underlying financial data.

.48 The following list of analytical procedures is for illustrative purposes only. These analytical procedures will not necessarily be applicable in every review engagement, nor are these analytical procedures meant to be all-inclusive. These illustrative analytical procedures are not intended to serve as a program or checklist to be utilized in performing a review engagement. Examples of analytical procedures an accountant may consider performing in a review of financial statements include the following:

- Comparing financial statements with statements for comparable prior period(s).
- Comparing current financial information with anticipated results, such as budgets or forecasts (for example, comparing tax balances and the relationship between the provision for income taxes and pretax income in the current financial information with corresponding information in (*a*) budgets, using expected rates, and (*b*) financial information for prior periods).[3]
- Comparing current financial information with relevant nonfinancial information.
- Comparing ratios and indicators for the current period with expectations based on prior periods, for example, performing gross profit analysis by product line and operating segment using elements of the current financial information and comparing the results with corresponding information for prior periods. Examples of key ratios and indicators are the current ratio, receivables turnover or days' sales outstanding, inventory turnover, depreciation to average fixed assets, debt to equity, gross profit percentage, net income percentage, and plant operating rates.
- Comparing ratios and indicators for the current period with those of entities in the same industry.
- Comparing relationships among elements in the current financial information with corresponding relationships in the financial information of prior periods, for example, expense by type as a percentage of sales, assets by type as a percentage of total assets, and percentage of change in sales to percentage of change in receivables.

.49 Analytical procedures may include such statistical techniques as trend analysis or regression analysis and may be performed manually or with the use of computer-assisted techniques.

.50 In addition, the accountant may find the guidance in AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1) useful in conducting a review of financial statements.

[3] The accountant should exercise caution when comparing and evaluating current financial information with budgets, forecasts, or other anticipated results because of the inherent lack of precision in estimating the future and the susceptibility of such information to manipulation and misstatement by management to reflect desired results.

.51 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)[4]

(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 using the information would be changed or influenced by the omission or misstatement.[5]

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

1. The financial statements referred to 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 acknowledge our responsibility to prevent and detect fraud.
5. We have no knowledge of any fraud or suspected fraud affecting the entity involving management or others where the fraud could have a material effect on the financial statements, including any communications received from employees, former employees, or others.
6. We have no plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities.

[†] In February 2008, the ARSC issued SSARS No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008*, which, among other things, amends appendix F of AR section 100A, from which this illustrative representation letter is derived. The amendment is effective for periods ending on or after December 15, 2008, with early application permitted. Readers should refer to SSARS No. 17 for the amendments.

[4] This date should be the date that the letter is presented and signed by the client. In no event should the letter be presented and signed prior to the completion of the review.

[5] 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.*

7. 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.

8. 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 that must be disclosed in accordance with Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies.*[6]

   c. other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB Statement No. 5.

9. The company has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets, nor has any asset been pledged as collateral, except as disclosed to you and reported in the financial statements.

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

11. 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 (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* [Significant estimates are estimates at the balance sheet date that could change materially with the next year. *Concentrations* refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.]

    [*Add additional representations that are unique to the entity's business or industry. See below for additional illustrative representations.*]

12. We are in agreement with the adjusting journal entry you have recommended, and they have been posted to the company's account. *(if applicable)*

13. 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.[7]

14. 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)

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

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

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

[7] If the accountant "dual dates" his or her report, the accountant should consider whether obtaining additional representations relating to the subsequent event is appropriate.

Representation letters ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry. The following is a list of additional representations that may be appropriate in certain situations. This list is not intended to be all inclusive. The accountant should consider the effects of pronouncements issued subsequent to the issuance of this section.

General	
Condition	**Illustrative Examples**
The impact of a new accounting principle is not known.	We have not completed the process of evaluating the impact that will result from adopting Financial Accounting Standards Board (FASB) Statement No. *[XXX, Name]*, as discussed in Note [*X*]. The company is therefore unable to disclose the impact that adopting FASB Statement No. [*XXX*] will have on its financial position and the results of operations when such statement is adopted.
There is justification for a change in accounting principles.	We believe that [*describe the newly adopted accounting principle*] is preferable to [*describe the former accounting principle*] because [*describe management's justification for the change in accounting principles*].
Financial circumstances are strained, with disclosure of management's intentions and the entity's ability to continue as a going concern.	Note [*X*] to the financial statements discloses all of the matters of which we are aware that are relevant to the company's ability to continue as a going concern, including significant conditions and events, and management's plans.
The possibility exists that the value of specific significant long lived assets or certain identifiable intangibles may be impaired.	We have reviewed long lived assets and certain identifiable intangibles to be held and used for impairment whenever events or changes in circumstances have indicated that the carrying amount of its assets might not be recoverable and have appropriately recorded the adjustment.

(continued)

The entity has a variable interest in another entity.	Variable interest entities (VIEs) and potential VIEs and transactions with VIEs and potential VIEs have been properly recorded and disclosed in the financial statements in accordance with GAAP. We have considered both implicit and explicit variable interests in (*a*) determining whether potential VIEs should be considered VIEs, (*b*) calculating expected losses and residual returns, and (*c*) determining which party, if any, is the primary beneficiary. We have provided you with lists of all identified variable interests in (*a*) VIEs, (*b*) potential VIEs that we considered but judged not to be VIEs, and (*c*) entities that were afforded the scope exceptions of FASB Interpretation (FIN) No. 46R, *Consolidation of Variable Interest Entities*. We have advised you of all transactions with identified VIEs, potential VIEs, or entities afforded the scope exceptions of FIN No. 46R. We have made available all relevant information about financial interests and contractual arrangements with related parties, de facto agents, and other entities, including but not limited to their governing documents, equity and debt instruments, contracts, leases, guarantee arrangements, and other financial contracts and arrangements. The information we provided about financial interests and contractual arrangements with related parties, de facto agents, and other entities includes information about all transactions, unwritten understandings, agreement modifications, and written and oral side agreements. Our computations of expected losses and expected residual returns of entities that are VIEs and potential VIEs are based on the best information available and include all reasonably possible outcomes. Regarding entities in which the Company has variable interests (implicit and explicit), we have provided all information about events and changes in circumstances that could potentially cause reconsideration about whether the entities are VIEs or whether the Company is the primary beneficiary or has a significant variable interest in the entity. We have made and continue to make exhaustive efforts to obtain information about entities in which the Company has an implicit or explicit interest but that were excluded from complete analysis under FIN No. 46R due to lack of essential information to determine one or more of the following: whether the entity is a VIE, whether the Company is the primary beneficiary, or what accounting is required to consolidate the entity.

The work of a specialist has been used by the entity.	We agree with the findings of specialists in evaluating the [*describe assertion*] and have adequately considered the qualifications of the specialist in determining the amounts and disclosures used in the financial statements and underlying accounting records. We did not give or cause any instructions to be given to specialists with respect to the values or amounts derived in an attempt to bias their work, and we are not otherwise aware of any matters that have had an impact on the independence or objectivity of the specialists.
	Assets
Condition	**Illustrative Examples**
Cash Disclosure is required of compensating balances or other arrangements involving restrictions on cash balances, line of credit, or similar arrangements.	Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances, lines of credit, or similar arrangements have been properly disclosed.
Financial Instruments Management intends to and has the ability to hold to maturity debt securities classified as held-to-maturity.	Debt securities that have been classified as held-to-maturity have been so classified due to the company's intent to hold such securities to maturity and the company's ability to do so. All other debt securities have been classified as available-for-sale or trading.
Management considers the decline in value of debt or equity securities to be temporary.	We consider the decline in value of debt or equity securities classified as either available-for-sale or held-to-maturity to be temporary.
Management has determined the fair value of significant financial instruments that do not have readily determinable market values.	The methods and significant assumptions used to determine fair values of financial instruments are as follows: [*describe methods and significant assumptions used to determine fair values of financial instruments*]. The methods and significant assumptions used result in a measure of fair value appropriate for financial statement measurement and disclosure purposes.
There are financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk.	The following information about financial instruments with off-balance-sheet risk and financial instruments with concentrations of credit risk has been properly disclosed in the financial statements: 1. The extent, nature, and terms of financial instruments with off-balance-sheet risk 2. The amount of credit risk of financial instruments with off-balance-sheet risk and information about the collateral supporting such financial instruments 3. Significant concentrations of credit risk arising from all financial instruments and information about the collateral supporting such financial instruments

(continued)

Receivables Receivables have been recorded in the financial statements.	Receivables recorded in the financial statements represent valid claims against debtors for sales or other charges arising on or before the balance sheet date and have been appropriately reduced to their estimated net realizable value.
Inventories Excess or obsolete inventories exist.	Provision has been made to reduce excess or obsolete inventories to their estimated net realizable value.
Investments There are unusual considerations involved in determining the application of equity accounting.	[*For investments in common stock that are either nonmarketable or of which the entity has a 20 percent or greater ownership interest, select the appropriate representation from the following:*] • The equity method is used to account for the company's investment in the common stock of [investee] because the company has the ability to exercise significant influence over the investee's operating and financial policies. • The cost method is used to account for the company's investment in the common stock of [in vestee] because the company does not have the ability to exercise significant influence over the investee's operating and financial policies.
Deferred Charges Material expenditures have been deferred.	We believe that all material expenditures that have been deferred to future periods will be recoverable.
Deferred Tax Assets A deferred tax asset exists at the balance sheet date.	The valuation allowance has been determined pursuant to the provisions of FASB Statement No. 109, *Accounting for Income Taxes*, including the company's estimation of future taxable income, if necessary, and is adequate to reduce the total deferred tax asset to an amount that will more likely than not be realized. [*Complete with appropriate wording detailing how the entity determined the valuation allowance against the deferred tax asset*.] or A valuation allowance against deferred tax assets at the balance sheet date is not considered necessary because it is more likely than not the deferred tax asset will be fully realized.

Liabilities	
Condition	**Illustrative Examples**
Debt Short-term debt could be refinanced on a long-term basis and management intends to do so.	The company has excluded short-term obligations totaling $[*amount*] from current liabilities because it intends to refinance the obligations on a long-term basis. [*Complete with appropriate wording detailing how amounts will be refinanced as follows*:] • The Company has issued a long-term obligation [*debt security*] after the date of the balance sheet but prior to the issuance of the financial state ments for the purpose of refinancing the short- term obligations on a long-term basis. • The Company has the ability to consummate the refinancing by using the financing agreement re ferred to in Note [*X*] to the financial statements.
Tax-exempt bonds have been issued.	Tax-exempt bonds issued have retained their tax-exempt status.
Taxes Management intends to reinvest undistributed earnings of a foreign subsidiary.	We intend to reinvest the undistributed earnings of [*name of foreign subsidiary*].
Contingencies Estimates and disclosures have been made of environmental remediation liabilities and related loss contingencies.	Provision has been made for any material loss that is probable from environmental remediation liabilities associated with [*name of site*]. We believe that such estimate is reasonable based on available information and that the liabilities and related loss contingencies and the expected outcome of uncertainties have been adequately described in the company's financial statements.
Agreements may exist to repurchase assets previously sold.	Agreements to repurchase assets previously sold have been properly disclosed.
Pension and Postretirement Benefits An actuary has been used to measure pension liabilities and costs.	We believe that the actuarial assumptions and methods used to measure pension liabilities and costs for financial accounting purposes are appropriate in the circumstances.
There is involvement with a multiemployer plan.	We are unable to determine the possibility of a withdrawal liability in a multiemployer benefit plan. or We have determined that there is the possibility of a withdrawal liability in a multiemployer plan in the amount of $[*XX*].
Postretirement benefits have been eliminated.	We do not intend to compensate for the elimination of postretirement benefits by granting an increase in pension benefits. or We plan to compensate for the elimination of postretirement benefits by granting an increase in pension benefits in the amount of $[*XX*].

(continued)

Employee layoffs that would otherwise lead to a curtailment of a benefit plan are intended to be temporary.	Current employee layoffs are intended to be temporary.
Management intends to either continue to make or not make frequent amendments to its pension or other postretirement benefit plans, which may affect the amortization period of prior service cost, or has expressed a substantive commitment to increase benefit obligations.	We plan to continue to make frequent amendments to its pension or other postretirement benefit plans, which may affect the amortization period of prior service cost. or We do not plan to make frequent amendments to its pension or other postretirement benefit plans.
Equity	
Condition	**Illustrative Example**
There are capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.	Capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements have been properly disclosed.
Income Statement	
Condition	**Illustrative Examples**
There may be a loss from sales commitments.	Provisions have been made for losses to be sustained in the fulfillment of or from inability to fulfill any sales commitments.
There may be losses from purchase commitments.	Provisions have been made for losses to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of prevailing market prices.
Nature of the product or industry indicates the possibility of undisclosed sales terms.	We have fully disclosed to you all sales terms, including all rights of return or price adjustments and all warranty provisions.

.52 Review of Financial Statements—Illustrative Updating Representation Letter

Management need not repeat all of the representations made in the previous representation letter.

If matters exist that should be disclosed to the accountant, they should be indicated by listing them following the representation. For example, if an event subsequent to the date of the accountant's review report is disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred…"[8]

[*Date*]

To [*Accountant*]

In connection with your review(s) of the [*identification of financial statements*] of [*name of entity*] as of [*dates*] and for the [*periods of review*] for the purpose of expressing limited assurance that there are no material modifications that should be made to the statements for them to be 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 accountant or date of previous representation letter*] and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

____

(Name of Owner or Chief Executive Officer and Title)

____

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

[8] The accountant has two methods available for dating the report when a subsequent event requiring disclosure occurs after the completion of the review but before issuance of the report on the related financial statements. The accountant may use "dual dating," for example, "February 16, 20XX, except for Note Y, as to which the date is March 1, 20XX," or may date the report as of the later date.

.53 Review of Financial Statements—Illustrative Inquiries

The inquiries to be made in a review of financial statements are a matter of the accountant's professional judgment. In determining the appropriate inquiries, an accountant may consider (a) the nature and materiality of the items reflected in the financial statements, (b) the likelihood of a misstatement in the financial statements, (c) knowledge obtained during current and previous engagements, (d) the stated qualifications of the entity's accounting personnel, (e) the extent to which a particular item is affected by management's judgment, and (f) inadequacies in the entity's underlying financial data. The inquiries should generally be made of members of management with financial reporting and accounting responsibilities.

The following list of inquiries is for illustrative purposes only. These inquiries will not necessarily be applicable in every review engagement, nor are these inquiries meant to be all-inclusive. These illustrative inquiries are not intended to serve as a program or checklist to be utilized in performing a review engagement; rather, they address general areas where inquiries might be made in a review engagement. These sample inquiries can also be found in appendix B of AR section 100A. Also, the accountant may feel it necessary to make several inquiries in an effort to answer questions related to the issues addressed in these illustrative inquiries.

1. General

   a. Have there been any changes in the entity's business activities?

   b. Are there any unusual or complex situations that may have an effect on the financial statements (for example, business combinations, restructuring plans, or litigation)?

   c. What procedures are in place related to recording, classifying, and summarizing transactions and accumulating information related to financial statement disclosures?

   d. Have the financial statements been prepared in conformity with generally accepted accounting principles or, if appropriate, a comprehensive basis of accounting other than generally accepted accounting principles? Have there been any changes in accounting principles and methods of applying those principles? Have voluntary changes in accounting principles been reflected in the financial statements through retrospective application of the new principle in comparative financial statements?

   e. Have there been any instances of fraud or illegal acts within the entity?

   f. Have there been any allegations or suspicions that fraud or illegal acts might have occurred or might be occurring within the entity? If so, where and how?

   g. Are any entities, other than the reporting entity, commonly controlled by the owners? If so, has an evaluation been performed to determine whether those other entities should be consolidated into the financial statements of the reporting entity?

   h. Are there any entities other than the reporting entity in which the owners have significant investments (for example, variable interest entities)? If so, has an evaluation been performed to determine whether the reporting entity is the primary beneficiary related to the activities of these other entities?

   i. Is the reporting entity a general partner in a limited partnership arrangement? If so, has an evaluation been performed to determine whether the limited partnership should be consolidated into the financial statements of the reporting entity?

   j. Is the reporting entity a controlling partner in a general partnership agreement? If so, has an evaluation been performed to determine whether the partnership should be consolidated into the financial statements of the controlling partner?

   k. Have any significant transactions occurred or been recognized near the end of the reporting period?

2. Cash and cash equivalents

   a. Is the entity's policy regarding the composition of cash and cash equivalents in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows* (paragraphs 7–10)? Has the policy been applied on a consistent basis?

   b. Are all cash and cash equivalents[9] accounts on a timely basis?

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

   d. Has there been a proper cutoff of cash receipts and disbursements?

   e. Has a reconciliation of intercompany transfers been prepared?

   f. Have checks written but not mailed as of the financial statement date been properly reclassified into the liability section of the balance sheet?

   g. Have material bank overdrafts been properly reclassified into the liability section of the balance sheet?

   h. Are there compensating balances or other restrictions on the availability of cash and cash equivalents balances? If so, has consideration been given to reclassifying these amounts as noncurrent assets?

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

3. Receivables

   a. Has an adequate allowance for doubtful accounts been properly reflected in the financial statements?

   b. Have uncollectible receivables been written off through a charge against the allowance account or earnings?

   c. Has interest earned on receivables been properly reflected in the financial statements?

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

   e. Are there receivables from employees or other related parties? Have receivables from owners been evaluated to determine if they should be reflected in the equity section (rather than the asset section) of the balance sheet?

   f. Are any receivables pledged, discounted, or factored? Are recourse provisions properly reflected in the financial statements?

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

   h. Have there been significant numbers of sales returns or credit memoranda issued subsequent to the balance sheet date?

   i. Is the accounts receivable subsidiary ledger reconciled to the general ledger account balance on a regular basis?

4. Inventory

   a. Are physical inventory counts performed on a regular basis, including at the end of the reporting period? Are the count procedures adequate to ensure an appropriate count? If not,

[9] Cash and cash equivalents include all cash and highly liquid investments that are both (*a*) readily convertible to cash and (*b*) so near to maturity that they present insignificant risk of changes in value because of changes in interest rates, in accordance with paragraph 8 of FASB Statement No. 95, *Statement of Cash Flows*.

how have amounts related to inventories been determined for purposes of financial statement presentation? If so, what procedures were used to take the latest physical inventory and what date was that inventory taken?

b. Have general ledger control accounts been adjusted to agree with the physical inventory count? If so, were the adjustments significant?

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

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

e. What is the basis of valuing inventory for purposes of financial statement presentation?

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

g. Has inventory been reviewed for obsolescence or cost in excess of net realizable value? If so, how are these costs reflected in the financial statements?

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

i. Are there any inventory encumbrances?

j. Is scrap inventoried and controlled?

k. Have abnormal costs related to inventory been expensed as incurred?

5. Prepaid expenses

a. What is the nature of the amounts included in prepaid expenses?

b. How are these amounts being amortized?

6. Investments

a. What is the basis of accounting for investments reported in the financial statements (for example, securities, joint ventures, or closely held businesses)?

b. Are derivative instruments properly measured and disclosed in the financial statements? If those derivatives are utilized in hedge transactions, have the documentation or assessment requirements related to hedge accounting been met?

c. Are investments in marketable debt and equity securities properly classified as trading, available-for-sale, and held-to-maturity?

d. How were fair values of the reported investments determined? Have unrealized gains and losses been properly reported in the financial statements?

e. If the fair values of marketable debt and equity securities are less than cost, have the declines in value been evaluated to determine whether the declines are other-than-temporary?

f. For any debt securities classified as held-to-maturity, does management have the positive ability and intent to hold the securities until they mature? If so, have those debt securities been properly measured?

g. Have gains and losses related to disposal of investments been properly reflected in the financial statements?

h. How was investment income determined? Is investment income properly reflected in the financial statements?

i. Has appropriate consideration been given to the classification of investments between current and noncurrent?

j. For investments made by the reporting entity, have consolidation, equity, or cost method accounting requirements been considered?

k. Are any investments encumbered?

7. Property and equipment

a. Are property and equipment items properly stated at depreciated cost or other proper value?

b. When was the last time a physical inventory of property and equipment was taken?

c. Are all items reflected in property and equipment held for use? If not, have items that are held for sale been properly reclassified from property and equipment?

d. Have gains or losses on disposal of property or equipment been properly reflected in the financial statements?

e. What are the criteria for capitalization of property and equipment? Have the criteria been consistently and appropriately applied?

f. Are repairs and maintenance costs properly reflected as an expense in the income statement?

g. What depreciation methods and rates are utilized in the financial statements? Are these methods and rates appropriate and applied on a consistent basis?

h. Are there any unrecorded additions, retirements, abandonments, sales, or trade-ins?

i. Does the entity have any material lease agreements? If so, have those agreements been properly evaluated for financial statement presentation purposes?

j. Are there any asset retirement obligations associated with tangible long-lived assets? If so, has the recorded amount of the related asset been increased because of the obligation and is the liability properly reflected in the liability section of the balance sheet?

k. Has the entity constructed any of its property and equipment items? If so, have all components of cost been reflected in measuring these items for purposes of financial statement presentation, including, but not limited to, capitalized interest?

l. Has there been any significant impairment in value of property and equipment items? If so, has any impairment loss been properly reflected in the financial statements?

m. Are any property or equipment items mortgaged or otherwise encumbered? If so, are these mortgages and encumbrances properly reflected in the financial statements?

8. Intangibles and 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 related to these assets? Is this policy appropriate?

c. Have other assets been properly classified between current and noncurrent?

d. Are intangible assets with finite lives being appropriately amortized?

e. Are the costs associated with computer software properly reflected as intangible assets (rather than property and equipment) in the financial statements?

f. Are the costs associated with goodwill (and other intangible assets with indefinite lives) properly reflected as intangible assets in the financial statements? Has amortization ceased related to these assets?

g. Has there been any significant impairment in value of these assets? If so, has any impairment loss been properly reflected in the financial statements?

h. Are any of these assets mortgaged or otherwise encumbered?

9. Accounts and short-term notes payable and accrued liabilities

a. Have significant payables been reflected in the financial statements?

b. Are loans from financial institutions and other short-term liabilities properly classified in the financial statements?

c. Have significant accruals (for example, payroll, interest, provisions for pension and profit-sharing plans, or other postretirement benefit obligations) been properly reflected in the financial statements?

d. Has a liability for employees' compensation for future absences been properly accrued and disclosed in the financial statements?

e. Are any liabilities collateralized or subordinated? If so, are those liabilities disclosed in the financial statements?

f. Are there any payables to employees or related parties?

10. Long-term liabilities

a. Are the terms and other provisions of long-term liability agreements properly disclosed in the financial statements?

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

c. Has interest expense been properly accrued and reflected in the financial statements?

d. Is the company in compliance with loan covenants and agreements? If not, is the noncompliance properly disclosed in the financial statements?

e. Are any long-term liabilities collateralized or subordinated? If so, are these facts disclosed in the financial statements?

f. Are there any obligations that, by their terms, are due on demand within one year from the balance sheet date? If so, have these obligations been properly reclassified into the current liability section of the balance sheet?

11. Income and other taxes

a. Do the financial statements reflect an appropriate provision for current and prior-year income taxes payable?

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

c. Are there any temporary differences between book and tax amounts? If so, have deferred taxes on these differences been properly reflected in the financial statements?

d. Do the financial statements reflect an appropriate provision for taxes other than income taxes (for example, franchise, sales)?

e. Have all required tax payments been made on a timely basis?

f. Has the entity assessed uncertain tax positions and related disclosures in accordance with FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*?

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 guarantees, whether written or verbal, whereby the entity must stand ready to perform or is contingently liable related to the guarantee? If so, are these guarantees properly reflected in the financial statements?

d. Are there any contingent liabilities (for example, discounted notes, drafts, endorsements, warranties, litigation, and unsettled asserted claims)? Are there any potential unasserted claims? Are these contingent liabilities, claims, and assessments properly measured and disclosed in the financial statements?

e. Are there any material, contractual obligations for construction or purchase of property and equipment or any commitments or options to purchase or sell company securities? If so, are these facts clearly disclosed in the financial statements?

f. Is the entity responsible for any environmental remediation liability? If so, is this liability properly measured and disclosed in the financial statements?

g. Does the entity have any agreement to repurchase items that previously were sold? If so, have the repurchase agreements been taken into account in determining the appropriate measure ments and disclosures in the financial statements?

h. Does the entity have any sales commitments at prices expected to result in a loss at the consummation of the sale? If so, are these commitments properly reflected in the financial statements?

i. Are there any violations, or possible violations, of laws or regulations the effects of which should be considered for financial statement accrual or disclosure?

13. Equity

a. What is the nature of any changes in equity accounts during each reporting period?

b. What classes of stock (other ownership interests) have been authorized?

c. What is the par or stated value of the various classes of stock (other ownership interests)?

d. Do amounts of outstanding shares of stock (other ownership interests) agree with subsidiary records?

e. Have pertinent rights and privileges of ownership interests been properly disclosed in the financial statements?

f. Does the entity have any mandatorily redeemable ownership interests? If so, have these ownership interests been evaluated so that a proper determination has been made related to whether these ownership interests should be measured and reclassified to the liability section of the balance sheet? Are redemption features associated with ownership interests clearly disclosed in the financial statements?

g. Have dividend (distribution) and liquidation preferences related to ownership interests been properly disclosed in the financial statements?

h. Do disclosures related to ownership interests include any applicable call provisions (prices and dates), conversion provisions (prices and rates), unusual voting rights, significant terms of contracts to issue additional ownership interests, or any other unusual features associated with the ownership interests?

i. Are syndication fees properly reflected in the financial statements as a reduction of equity (rather than an asset)?

j. Have any stock options or other stock compensation awards been granted to employees or others? If so, are these options or awards properly measured and disclosed in the financial statements?

k. Has the entity made any acquisitions of its own stock? If so, are the amounts associated with these reacquired shares properly reflected in the financial statements as a reduction in equity? Is the presentation in accordance with applicable state laws?

l. Are there any restrictions or appropriations on retained earnings or other capital accounts? If so, are these restrictions or appropriations properly reflected in the financial statements?

14. Revenue and expenses

a. What is the entity's revenue recognition policy? Is the policy appropriate? Has the policy been consistently applied and appropriately disclosed?

b. Are revenues from sales of products and rendering of services recognized in the appropriate reporting period (that is, when the products have been delivered and when the services have been performed)?

c. Were any sales recorded under a "bill and hold" arrangement? If yes, have the criteria been met to record the transaction as a sale?

d. Are purchases and expenses recognized in the appropriate reporting period (that is, matched against revenue) and properly classified in the financial statements?

e. Do the financial statements include discontinued operations or items that might be considered extraordinary, or both? If so, are amounts associated with discontinued operations, extraordinary items, or both properly displayed in the income statement?

f. Does the entity have any gains or losses that would necessitate the display of comprehensive income (for example, gains or losses on available-for-sale securities or cash flow hedge derivatives)? If so, have these items been properly displayed within comprehensive income (rather than included in the determination of net income)?

15. Other

a. Have events occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements?

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

c. Are significant estimates and material concentrations (for example, customers or suppliers) properly disclosed in the financial statements?

d. Are there plans or intentions that may materially affect the carrying amounts or classification of assets and liabilities reflected in the financial statements?

e. Have there been material transactions between or among related parties (for example, sales, purchases, loans, or leasing arrangements)? If so, are these transactions properly disclosed in the financial statements?

f. Are there uncertainties that could have a material impact on the financial statements? Is there any change in the status of previously disclosed material uncertainties? Are all uncertainties, including going concern matters, that could have a material impact on the financial statements, properly disclosed in the financial statements?

g. Are barter or other nonmonetary transactions properly recorded and disclosed? Have nonmonetary asset exchanges involving commercial substance been reflected in the financial statements at fair value? Have nonmonetary asset exchanges not involving commercial substance been reflected in the financial statements at carrying value?

.54 Illustrative Ratio Analysis Worksheet

In the following table, 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	Accounts Payable × (Days in a cycle)/Net Sales × (Days in a year)		Compares A/P balance to net sales
Return on total assets	Net Income × (Days in a year)/Total Assets × (Days in a cycle)		Measures profitability at a point in time
Return on net worth	Net Income × (Days in a year)/Net Worth × (Days in a cycle)		Profitability measure
Return on net sales	$\frac{\text{Net Income}}{\text{Net Sales}}$		Profit margin

Ratio Name	Formula	Calculation	Explanation
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
Days payables in cost of sales	$\frac{\text{A/P} \times (\text{Days in a cycle})}{\text{Cost of Sales}}$		
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	$\frac{\text{Net Sales - Cost of Sales}}{\text{Net Sales}}$		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):

$$\frac{\text{Working Capital}}{\text{Total Assets}} \times 6.56 =$$

$$\frac{\text{Retained Earnings}}{\text{Total Assets}} \times 3.26 =$$

$$\frac{\text{Income before Interest and Taxes}}{\text{Total Assets}} \times 6.72 =$$

$$\frac{\text{Net Worth}}{\text{Total Liabilities}} \times 1.05 =$$

Altman Z Score ______

For private companies (five variable):

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

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

.55 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 are typically 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 a mastery of a complex array of authoritative standards for measurement, presentation, and disclosure is needed.

Title Page

.02 A title page is recommended for all financial statement presentations. The title page typically contains 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 is ordinarily 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 may 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 (for example, 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 includes the words *consolidated* or *combined*. When financial statements include supplementary information, the title is modified. Some accountants 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 is typically shown, with the period ending date. When only a balance sheet is presented, the date is the balance sheet date, alone.

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* In February 2008, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), which amends some of the guidance for compilation and review engagements. SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. This manual will be updated for SSARS No. 17 in the next edition.

Due to the issuance of SSARS No. 17, AR sections 100, 9100, 200, 300, 9300, and 400 have been moved to AR sections 100A, 9100A, 200A, 300A, 9300A, and 400A, respectively, of *Professional Standards* until the effective date of SSARS No. 17. This manual references the "A" sections as appropriate because SSARS No. 17 has not been incorporated in this edition.

Presentation of the Accountant's Report

.06 This section discusses presentation and format of the accountant's report. AAM section 2600, *Reporting*, 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—for example, the signature could be manual, stamped, electronic, or typed—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 is 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.

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 generally accepted accounting principles (GAAP) financial statement presentation are as follows: (Note: Basic financial statements for an other comprehensive bases of accounting [OCBOA] presentation are discussed in AAM section 2700, *Special Areas*).

- Balance sheet
- Income statement
- Statement of retained earnings[1] or Changes in stockholders' equity
- Statement of cash flows

Heading

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

Reference on Financial Statements

.15 The following examples demonstrate how the type of reference or 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 (that is, 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 the following:
  - — *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 AR section 300A, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* [AICPA, *Professional Standards*, vol. 2]), 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 (AR section 600, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* [AICPA, *Professional Standards*, vol. 2]), each of the personal financial statements should contain a reference to the report, such as: *See Accountant's Report*.

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[1] The accounting literature does not require the statement of retained earnings to be presented as a separate 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 (because the footnotes are part of the financial statements). However, there is diversity in practice as to how to meet this requirement for footnotes. Some accountants 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 previous references are examples given in Statements on Standards for Accounting and Review Services (SSARS), and the accountant may modify the wording of the reference. AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2) states 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 accountants 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 accountants 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 the following:

- 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 typically follows the title page.

Reporting

.21 The accountant should 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 is typically 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 may 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 (for example, 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 typically are not 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 generally contains a general reference to the notes. If selected information rather than all notes is presented in a compilation, a reference to the selected information is ordinarily included.

[*The next page is 2551.*]

AAM Section 2600

*Reporting**

Reporting Obligation

.01 AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2) discusses the accountant's reporting obligation for compilation and review engagements. In summary, it says the following:

- 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 (paragraph .01 of AR section 100A)
- 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 AR section 100A, 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. (paragraph .03 of AR section 100A)
- The accountant should issue a report prepared in accordance with Statements on Standards for Accounting and Review Services (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 (paragraph .11 of AR section 100A)
- 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 (paragraph .41 of AR section 100A)

.02 The first item in the bulleted list above is addressed in paragraph .01 of AR section 100A. 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.

.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 should 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.

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* In February 2008, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), which amends some of the guidance for compilation and review engagements. SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. This manual will be updated for SSARS No. 17 in the next edition.

Due to the issuance of SSARS No. 17, AR sections 100, 9100, 200, 300, 9300, and 400 have been moved to AR sections 100A, 9100A, 200A, 300A, 9300A, and 400A, respectively, of *Professional Standards* until the effective date of SSARS No. 17. This manual references the "A" sections as appropriate because SSARS No. 17 has not been incorporated in this edition.

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

Basic Compilation Reports

.05 The basic elements of a report on compiled financial statements are as follows:

- 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 (owners)
- 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 The basic elements of a report on financial statements reviewed by an accountant are as follows:

- 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 (owners) of the entity
- 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 generally accepted accounting principles (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.[1] He or she may, however, issue a compilation report.

[1] In making a judgment about whether he or she is independent, the accountant should be guided by the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2).

.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 (for example, 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 typically are not 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, "Omission of Disclosures in Reviewed Financial Statements," of AR section 100A (AICPA, *Professional Standards*, vol. 2, AR sec. 9100A par. .01), indicates that the above modification for compiled financial statements is not appropriate for reviewed financial statements. Because 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 the following 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, provided the accountant states 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, "Reporting When There Are Significant Departures From Generally Accepted Accounting Principles," of AR section 100A (AICPA, *Professional Standards*, vol. 2, AR sec. 9100 par. .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 (for example, 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, "Reporting on the Highest Level of Service," of AR section 100A (AICPA, *Professional Standards*, vol. 2, AR sec. 9100A par. .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 (for example, analytical procedures in a compilation engagement) do not require the issuance of the higher report.

.24 Interpretation No. 13, "Additional Procedures," of AR section 100A (AICPA, *Professional Standards*, vol. 2, AR sec. 9100 par. .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 SSARS do not preclude the accountant from performing procedures that he deems necessary or that his client requests.

.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 paragraph .48 of AR section 100A. 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 AR section 300A, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AICPA, *Professional Standards*, vol. 2), 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 as follows:

- 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 accountants 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 or Comprehensive Income Information Is Omitted, or Both

.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 should 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 the following:

- 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 The following are two common questions that 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. AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1), 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 the following:

- 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 accountants 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 typically follows the title page.

.40 Paragraph .70 of AR section 100A states that the accountant should clearly 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).
- 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. Paragraph .70 of AR section 100A 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, for example, 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 AR section 100A and AR section 200A, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2), 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 of some periods that have not been audited, reviewed, or compiled may be presented on separate pages of a document that also contains financial statements of other periods on which the accountant has reported if they are accompanied by 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 may 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 AR section 100A. Accordingly, the accountant generally does 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 will either compile, examine, or apply agreed upon procedures to the prospective information.

.50 An exception to this rule occurs for expired forecasts or projections, that is, 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, AR section 100A 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.

.53 In situations where the pro forma information is treated as supplementary information, the reporting guidance in AR section 100A should be followed. 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.

.54 According to paragraph .05 of AR section 120, *Compilation of Pro Forma Financial Information* (AICPA, *Professional Standards*, vol. 1) pro forma financial information should be labeled as such to distinguish it from historical financial information. This presentation should describe the transaction (or event) that is reflected in the pro forma financial information, the source of the historical financial information on which it is based, the significant assumptions used in developing the pro forma adjustments, and any significant uncertainties about those assumptions. The presentation should also indicate that the pro forma financial information should be read in conjunction with the related historical financial information and that the pro forma financial information is not necessarily indicative of the results (such as financial position and results of operations, as applicable) that would have been attained had the transaction (or event) actually taken place earlier.

.55 If an accountant prepares or assists a client in preparing pro forma financial information, the accountant should consider how the presentation of pro forma financial information will be used. The accountant should also consider the potential of being associated with pro forma financial information and the likelihood that the user may inappropriately infer, through that association, an unintended level of assurance. If the accountant believes that he or she will be associated with the information, the accountant should consider issuing a compilation report so a user will not infer a level of assurance that does not exist.

.56 An engagement to compile pro forma financial information may be undertaken as a separate engagement or in conjunction with a compilation of financial statements. The accountant may agree to compile pro forma financial information if the document that contains the pro forma financial information includes (or incorporates by reference) complete historical financial statements of the entity for the most recent year (or for the preceding year if financial statements for the most recent year are not yet available) and, if pro forma financial information is presented for an interim period, the document also includes (or incorporates by reference) historical interim financial information for that period (which may be presented in condensed form). In the case of a business combination, the document should include (or incorporate by reference) the appropriate historical financial information for the significant constituent parts of the combined entity.

.57 Additionally, the historical financial statements of the entity (or, in the case of a business combination, of each significant constituent part of the combined entity) on which the pro forma financial information is based must have been compiled, reviewed, or audited. The accountant's compilation or review report or the auditor's report on the historical financial statements should be included (or incorporated by reference) in the document containing the pro forma financial information.

.58 Before issuance of a compilation report on pro forma financial information, the accountant should read such compiled pro forma financial information, including the summary of significant assumptions,[2] and consider whether the information appears to be appropriate in form and free of obvious material errors. In this context, the term *error* refers to mistakes in the compilation of the pro forma financial information, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including disclosures, if presented. The accountant may not report on compiled pro forma financial information if the summary of significant assumptions is not presented. If the accountant reports on compiled pro forma financial information when management elects to omit substantially all disclosures, then the accountant should follow the guidance in paragraph .17 of AR section 100A.

.59 When the accountant is engaged to compile or issues a compilation report on pro forma financial information, the basic elements of the report are as follows:

a. An identification of the pro forma financial information.

b. A statement that the compilation was performed in accordance with SSARS issued by the American Institute of Certified Public Accountants.

c. A reference to the financial statements from which the historical financial information is derived and a statement on whether such financial statements were compiled, reviewed, or audited. (The report on pro forma financial information should refer to any modifications in the accountant's or auditor's report on historical financial statements.)

d. A statement that the pro forma financial information was compiled. If the compilation was performed in conjunction with a compilation of the company's financial statements, the paragraph should so state and indicate the date of the accountant's compilation report on those financial statements. Furthermore, any departure from the standard report on those statements should also be disclosed if considered relevant to the presentation of the pro forma financial information.

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[2] The accountant may not report on compiled pro forma financial information if the summary of significant assumptions is not presented. Nothing in this statement should be interpreted to preclude the accountant from reporting on compiled pro forma financial information when management elects to omit substantially all disclosures. In that situation, the accountant should follow the guidance in paragraphs .17–.20 of AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2).

e. A description of the basis on which the pro forma financial information is presented if that basis is not generally accepted accounting principles and a statement that that basis of presentation is a comprehensive basis of accounting other than GAAP.

f. A statement that a compilation is limited to presenting pro forma financial information that is the representation of management (owners).

g. A statement that the pro forma financial information has not been audited or reviewed and, accordingly, the accountant does not express an opinion or any other form of assurance on it.

h. A separate paragraph explaining the objective of pro forma financial information and its limitations.

i. A signature of the accounting firm or the accountant as appropriate. (The signature could be manual, stamped, electronic, or typed.)

j. The date of the compilation report. (The date of completion of the compilation should be used as the date of the accountant's report.)

.60 Each page of the compiled pro forma financial information should include a reference, such as "See Accountant's Compilation Report."

Supplementary Information Presented Without Financial Statements

.61 Because 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

.62 Common examples of charts and graphs prepared for clients include the following:

- 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

.63 When the basic financial statements are accompanied by information in the form of a chart or graph, such information may be considered supplementary information. The accountant may wish to consider the following basic issues:

- Accountants ordinarily should check for consistency if the same information is presented numerically in the basic financial statements and graphically in supplementary information.
- Accountants ordinarily 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 ordinarily includes a reference to the accountant's report.

Stand Alone Charts and Graphs

.64 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

.65 In accordance with paragraph .49 of AR section 100A, an accountant may emphasize, in any report on financial statements, a matter disclosed in the financial statements. Such explanatory information should be presented in a separate paragraph of the accountant's report. Emphasis paragraphs are never required; they may be added solely at the accountant's discretion. Examples of matters the accountant may wish to emphasize are as follows:

- Uncertainties
- That the entity is a component of a larger business enterprise
- That the entity has had significant transactions with related parties
- Unusually important subsequent events
- Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period

.66 Because an emphasis of matter paragraph should not be used in lieu of management disclosures, an accountant should not include an emphasis paragraph in a compilation report on financial statements that omit substantially all disclosures unless the matter is disclosed in the financial statements. For example, the accountant may include an emphasis paragraph on a matter when management has presented selected information, even though substantially, all disclosures have been omitted, as long as the matter discussed in the emphasis paragraph is disclosed in the selected information. The accountant should refer to paragraph .17 of AR section 100A if he or she believes that a disclosure is necessary to keep the financial statements from being misleading.

Going Concern Issues

Full Disclosure Financial Statements

.67 As stated in footnote 30 in paragraph .52 of AR section 100A, "Normally, neither an uncertainty, including an uncertainty about an entity's ability to continue as a going concern, nor an inconsistency in the application of accounting principles would cause the accountant to modify the standard report provided the financial statements appropriately disclose such matters." According to Interpretation No. 29, "Reporting on an Uncertainty Including, an Uncertainty About an Entity's Ability to Continue as a Going Concern," of AR section 100A (AICPA, *Professional Standards*, vol. 2, AR sec. 9100A par. .120–.129) information. Continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. If, during the performance of compilation or review procedures, evidence or information comes to the accountant's attention that there may be an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being compiled or reviewed, the accountant should consider the adequacy of management's disclosure of the uncertainty. If management has not disclosed the matter or the accountant is concerned about the adequacy of management's disclosure, the accountant should consider whether there is a reasonable possibility that third-party users or other readers of the compiled or reviewed financial statements would be misled into assuming the continuation of the entity. If the accountant determines that the disclosure of the uncertainty regarding the entity's ability to continue as a going concern is not adequate, he or she should follow the guidance in paragraphs .51–.53 of AR section 100A with respect to departures from GAAP.

.68 If the accountant concludes that management's disclosure of the uncertainty regarding the entity's ability to continue as a going concern is adequate, but further decides to include an emphasis of a matter paragraph with respect to the uncertainty in the accountant's compilation or review report, he or she may use the following language:

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

Omission of Substantially All Disclosures

.69 The accountant may compile financial statements for a client that omit substantially all disclosures required by GAAP or other comprehensive bases of accounting (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.[3]

.70 Because 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.

.71 Although not required, the going concern matter can be disclosed. In this case, however, the disclosure might be made in the financial statements. Keep in mind that emphasis paragraphs ordinarily do not introduce new information about the financial statements. Rather, they 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.

Reporting on Computer Prepared Financial Statements

.72 Computer prepared financial statements for interim or annual periods that contain disclosure omissions or measurement departures should be reported on in accordance with AR section 100A. 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 AR section 100A.

Reporting When There Is a Scope Limitation

.73 Scope limitations occur in audit engagements when the auditor is prevented from applying generally accepted auditing standards (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, AR section 100A does not permit such reporting.

.74 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. Paragraph .46 of AR section 100A 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.

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[3] Note that the accountant cannot review financial statements that omit substantially all disclosures.

.75 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 may consider the following:

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

.76 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. Paragraph .09 of AR section 100A states that the accountant should withdraw from the engagement if the client refuses to provide additional or revised information. A scope restriction resulting from inadequate accounting records is normally 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 are rare ordinarily. One such situation may be when accounting records have been destroyed.

.77 When there has been a scope restriction that precludes a review report, and the accountant decides to issue a compilation report, paragraph .78 of AR section 100A indicates he or she should issue an appropriate compilation report without any reference to the scope restriction.

.78 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 can 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 Management Consulting Services Reports

General

.79 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.

.80 The accountant should not submit unaudited financial statements of a nonissuer to his or her client or a third party unless, at a minimum, he or she complies with the provisions of AR section 100A applicable to a compilation engagement. This requirement extends to unaudited financial statements included in MCS reports.

Financial Statements Compiled or Reviewed by Another Accountant

.81 As discussed in paragraph .17 of AR section 200A, when the financial statements of a prior period have been compiled or reviewed by a predecessor whose report is not presented, and the successor has not compiled or reviewed those financial statements, the successor should make reference in an additional paragraph(s) of his report on the current period financial statements to the predecessor's report on the prior period financial statements. This reference should include the following matters:

a. A statement that the financial statements of the prior period were compiled or reviewed by another accountant (other accountants). The successor accountant should not disclose the name of the other accountant in his or her report; however, the successor accountant may name the predecessor accountant if the predecessor accountant's practice was acquired by or merged with that of the successor accountant

b. The date of his (their) report

c. A description of the standard form of disclaimer or limited assurance, as applicable, included in the report

d. A description or a quotation of any modifications of the standard compilation or review report and of any paragraphs emphasizing a matter regarding the financial statements

.82 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.

.83 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

.84 If the MCS report contains client prepared financial statements, the accountant is not required to compile and report in 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 because 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 may 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

.85 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

.86 AR section 200A, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2), establishes standards for reporting on comparative financial statements of a nonpublic entity when financial statements of one or more periods presented have been compiled and reported on or reviewed in accordance with AR section 100A. 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 the guidance in AR section 200A can be daunting.

.87 The following definitions from paragraph .07 of AR section 200A 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

.88 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.

.89 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

.90 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.

.91 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.

.92 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.

.93 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

.94 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 the following:

- 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

.95 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.

.96 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(s) (without identifying the predecessor by name).[4]
- 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.

.97 According to paragraph .20 of AR section 200A, 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.

.98 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. The predecessor should not refer in his reissued report to this letter or the report of the successor.

.99 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.

.100 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.

.101 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.

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[4] The successor accountant should not name the predecessor accountant in his or her report; however, the successor accountant may name the predecessor accountant if the predecessor accountant's practice was acquired by, or merged with that of the successor accountant.

Restated Prior Period Financial Statements

.102 When prior period financial statements have been restated,[5] the predecessor accountant would normally reissue his or her report following the guidance in paragraph .22 of AR section 200A. If the predecessor decides not to reissue his or her report, the successor accountant may be engaged to report on the financial statements for the prior year. If the predecessor accountant does not reissue his or her report and the successor accountant is not engaged to report on the prior year financial statements, the successor accountant should indicate in the introductory paragraph of his or her compilation or review report that a predecessor accountant reported on the financial statements of the prior period before restatement. In addition, if the successor accountant is engaged to compile or review the restatement adjustment(s), he or she may also indicate in the accountant's report that he or she compiled or reviewed the adjustment(s) that was (were) applied to restate prior year financial statements.

Reporting When Prior Period Is Audited

.103 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

.104 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

.105 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 AR section 200A. 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 successor accountant may name the predecessor accountant if the predecessor accountant's practice was acquired by or merged with that of the successor accountant.

Change of Accountants—Predecessor Accountant Has Ceased Operations

.106 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 the following:

- A statement that the prior period financial statements were compiled or reviewed by another accountant who has ceased operations

[5] See paragraphs .10–.11 of AR section 400A, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*, vol. 2), for guidance regarding communication to the predecessor accountant with respect to information that leads the successor accountant to believe that the financial statements reported on by the predecessor accountant may require revision.

- 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

.107 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 the following:

- That the prior period financial statements were audited by another firm
- 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 therefore
- That no auditing procedures were performed after the date of the predecessor's report

.108 If the prior period financial statements have been restated, the successor accountant may be engaged to report on the financial statements for the prior year. If the successor accountant is not engaged to report on the financial statements for the prior year, the successor accountant should indicate in the introductory paragraph of his compilation or review report that a predecessor accountant reported on the financial statements of the prior period before restatement. In addition, if the successor accountant is engaged to compile or review the restatement adjustment(s), he or she may also indicate in the accountant's report that he or she compiled or reviewed the adjustment(s) that was (were) applied to restate prior year financial statements.

Change of Status—Public/Nonpublic Entity

.109 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.

AR Section 200A Summary

.110 AR section 200A may be rather complex for some accountants. The following summary decision aid helps simplify the report decision process in AR section 200A. 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

.111 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

.112 If other accountants are engaged to audit or review the financial statements of a division, branch, subsidiary, or other investee, the accountant will 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.

Preliminary Financial Statement Drafts

.113 Interpretation No. 17, "Submitting Draft Financial Statements," of AR section 100A (AICPA, *Professional Standards*, vol. 2, AR sec. 9100A par. .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*.

.114 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[1]

Stockholders and Board of Directors

[*Company*]

I (We) have compiled the accompanying balance sheet of [*Company*] as of December 31, 20X6, and the related statements of income, retained earnings,[2] 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .14 of AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2)]

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[*] In February 2008, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), which amends some of the guidance for compilation and review engagements. SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. This manual will be updated for SSARS No. 17 in the next edition.

Due to the issuance of SSARS No. 17, AR sections 100, 9100, 200, 300, 9300, and 400 have been moved to AR sections 100A, 9100A, 200A, 300A, 9300A, and 400A, respectively, of *Professional Standards* until the effective date of SSARS No. 17. This manual references the "A" sections as appropriate because SSARS No. 17 has not been incorporated in this edition.

[1] If the statement of comprehensive income is included, the first paragraph of the report should also refer to this statement.

[2] 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.

.02 Omission of Substantially All Disclosures But Otherwise in Conformity With GAAP

Stockholders and Board of Directors

[*Company*]

I (We) have compiled the accompanying balance sheet of [*Company*] as of December 31, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .19 of AR section 100A]

.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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Paragraphs .14 and .21 of AR section 100A]

.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, 20X6, 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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .52 of AR section 100A]

.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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .52 of AR section 100A]

.06 Compilation Report With Departure From GAAP and 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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraphs .47 and .18 of AR section 100A]

.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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .14 of AR section 100A]

.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, 20X6 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .09 of AR section 200A, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2)]

.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 December 31, 20X6 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 December 31, 20X5 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, 20X7

[*Signature of CPA*]

[Source: Paragraphs .09 and .12 of AR section 200A]

.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 December 31, 20X6 and December 31, 20X5, 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 December 31, 20X5 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 December 31, 20X5 financial statements to [*describe correction*] in accordance with generally accepted accounting principles.

January 28, 20X6

[*Signature of CPA*]

[Source: Paragraphs .09 and .15 of AR section 200A]

.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 December 31, 20X6, 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 December 31, 20X5 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, 20X7

[*Signature of Successor CPA*]

[Source: Paragraphs .09 and .19 of AR section 200A]

.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 December 31, 20X6, 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 December 31, 20X5 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, 20X7

[*Signature of Successor CPA*]

[Source: Paragraphs .09 and .18 of AR section 200A]

.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 December 31, 20X6, 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 December 31, 20X5 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .29 of AR section 200A]

.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, 20X6 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 20X5 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, 20X6.

January 28, 20X7

[*Signature of CPA*]

[Source: Paragraph .31 of AR section 200A]

.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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .70 of AR section 100A]

.16 Compilation Report on Pro Forma Financial Information

Stockholders and Board of Directors

[*Company*]

I (we) have compiled the accompanying pro forma financial information as of and for the year ended December 31, 20X6, reflecting the business combination of the Company and ABC Company in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The historical condensed financial statements are derived from the historical unaudited financial statements of XYZ Company, which were compiled by me (us), and of ABC Company, which were compiled by another (other) accountant(s).[3]

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

The objective of this pro forma financial information is to show what the significant effects on the historical financial information might have been had the transaction (or event) occurred at an earlier date. However, the pro forma financial information is not necessarily indicative of the results of operations or related effects on financial position that would have been attained had the above mentioned transaction (or event) actually occurred earlier.

[*If the presentation does not include all applicable disclosures, the following paragraph should be added.*][4]

Management has elected to omit all of the disclosures ordinarily included in pro forma financial information. The omitted disclosures might have added significant information regarding the company's pro forma financial position and results of operations. Accordingly, this pro forma financial information is not designed for those who are not informed about such matters.

January XX, 20X7

[*Signature of CPA*]

[Source: Paragraph .16 of AR section 120, *Compilation of Pro Forma Financial Information* (AICPA, *Professional Standards*, vol. 2)]

[3] Where one set of historical financial statements is audited or reviewed and the other is audited, reviewed, or compiled, wording similar to the following would be appropriate:

> The historical condensed financial statements are derived from the historical financial statements of XYZ Company, which were compiled by me (us), and of ABC Company, which were reviewed by another (other) accountant(s), appearing elsewhere herein (or incorporated by reference).

If either accountant's review report or auditor's report includes an explanatory paragraph or is modified, that fact should be referred to within this report.

[4] The accountant may not report on compiled pro forma financial information if the summary of significant assumptions is not presented.

.17 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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Interpretation No. 29, "Reporting on an Uncertainty, Including an Uncertainty About an Entity's Ability to Continue as a Going Concern," of AR section 100A (AICPA, *Professional Standards*, vol. 2, AR sec. 9100A par. .120–.129)]

.18 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 December 31, 20X6, 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 December 31, 20X5 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, 20X7

[*Signature of Successor CPA*]

[Source: Derived from paragraph .18 of AR section 200A]

.19 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 December 31, 20X6, 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 December 31, 20X5 financial statements of [*Company*] were audited by other accountants 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, 20X7

[*Signature of Successor CPA*]

[Source: Derived from paragraph .29 of AR section 200A]

[*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, 20X6, and the related statements of income, retained earnings,[1] 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .44 of AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2)]

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* In February 2008, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), which amends some of the guidance for compilation and review engagements. SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. This manual will be updated for SSARS No. 17 in the next edition.

Due to the issuance of SSARS No. 17, AR sections 100, 9100, 200, 300, 9300, and 400 have been moved to AR sections 100A, 9100A, 200A, 300A, 9300A, and 400A, respectively, of *Professional Standards* until the effective date of SSARS No. 17. This manual references the "A" sections as appropriate because SSARS No. 17 has not been incorporated in this edition.

[1] Accounting Principles Board (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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .52 of AR section 100A]

.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, 20X6, 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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .47 of AR section 100A]

.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 December 31, 20X6 and December 31, 20X5, 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .09 of AR section 200A, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2)]

.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 December 31, 20X6, 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 December 31, 20X6 financial statements in order for them to be in conformity with generally accepted accounting principles.

The accompanying December 31, 20X5 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 December 31, 20X5 financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

January 28, 20X7

[*Signature of CPA*]

[Source: Paragraph .10 of AR section 200A]

.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 December 31, 20X6 and December 31, 20X5, 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 March 1, 20X6, on the December 31, 20X5 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 December 31, 20X5 financial statements to [*describe correction*] in accordance with generally accepted accounting principles.

January 28, 20X7

[*Signature of CPA*]

[Source: Paragraphs .09 and .15 of AR section 200A]

.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 December 31, 20X6, 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 December 31, 20X5 financial statements of [*Company*] were reviewed by other accountants whose report, dated March 1, 20X6, 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, 20X7

[*Signature of Successor CPA*]

[Source: Paragraphs .09 and .18 of AR section 200A]

.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 December 31, 20X6, 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 December 31, 20X5 financial statements of [*Company*] were compiled by other accountants whose report, dated March 1, 20X6, stated that they did not express an opinion or any other form of assurance on those statements.

January 28, 20X7

[*Signature of Successor CPA*]

[Source: Paragraphs .09 and .19 of AR section 200A]

.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 December 31, 20X6, 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 December 31, 20X5 financial statements were audited by us, and I (we) expressed an unqualified opinion on them in our report dated March 1, 20X6. I (we) have not performed any auditing procedures since that date.

January 28, 20X7

[*Signature of CPA*]

[Source: Paragraphs .09 and .29 of AR section 200A]

.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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .70 of AR section 100A]

.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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Paragraph .70 of AR section 100A]

.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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Interpretation No. 29, "Reporting on an Uncertainty, Including an Uncertainty About an Entity's Ability to Continue as a Going Concern," of AR section 100A (AICPA, *Professional Standards*, vol. 2, AR sec. 9100A par. .120–.129)]

.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, 20X6, 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, 20X5, were reviewed by other accountants whose report, dated March 1, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .18 of AR section 200A]

.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, 20X6, 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, 20X5, were audited by other accountants and they expressed an unqualified opinion on them in their report dated March 1, 20X6, but they have not performed any auditing procedures since that date.

January 28, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .29 of AR section 200A]

[*The next page is 2661.*]

AAM Section 2700

*Special Areas**

Other Comprehensive Bases of Accounting

.01 Paragraph .04 of AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), defines other comprehensive bases of accounting (OCBOA) as a definite set of criteria, other than generally accepted accounting principles (GAAP), having substantial support underlying the preparation of financial statements prepared pursuant to that basis. Paragraph .04 of section 100A 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. An example is a basis of accounting insurance companies use pursuant to the rules of a state insurance commission.
- 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 basis of accounting and modifications of the cash basis having substantial support (for example, recording depreciation on fixed assets). Ordinarily, a modification would have substantial support if the method is equivalent to the accrual basis of accounting for that item and if the method is not illogical. If modifications to the cash basis of accounting do not have substantial support, the accountant should appropriately modify his or her report in accordance with the guidance in paragraphs .51–.53 of AR section 100A. If the modifications are so extensive that the modified "cash basis" statements are, in the accountant's judgment, equivalent to financial statements on the accrual basis, the statements should be considered GAAP basis. The accountant may use the standard form of report, modified as appropriate, because of the departures from generally accepted accounting principles.

Deciding When to Use an OCBOA

.02 OCBOA financial statements are beneficial to clients for many reasons. Among them is the idea that the client and the 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.

.03 The accountant might consider the following characteristics of entities as good candidates for cash or tax basis financial statements:

- There are no third party users of financial statements (for example, 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.

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* In February 2008, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), which amends some of the guidance for compilation and review engagements. SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. This manual will be updated for SSARS No. 17 in the next edition.

Due to the issuance of SSARS No. 17, AR sections 100, 9100, 200, 300, 9300, and 400 have been moved to AR sections 100A, 9100A, 200A, 300A, 9300A, and 400A, respectively, of *Professional Standards* until the effective date of SSARS No. 17. This manual references the "A" sections as appropriate because SSARS No. 17 has not been incorporated in this edition.

- The cost of complying with GAAP would exceed the benefits.
- 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.

.04 In advising clients about the use of an OCBOA, accountants might 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

.05 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

.06 Titles of OCBOA financial statements differ from titles of similar statements prepared in accordance with GAAP. The following table lists some suggested titles for OCBOA financial statements.

Table 2700-1
Suggested OCBOA Statement Titles

GAAP	*Cash Basis*	*Tax Basis*
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

GAAP	*Cash Basis*	*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.
- 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

.07 Authoritative accounting literature does not address OCBOA or the disclosures necessary in such presentations. As a best practice, cash, modified cash, and income tax basis financial statements ordinarily should be informative of matters that may affect their use, understanding, and interpretation. For example:

- The financial statements could include a brief 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 may be appropriate (for example, depreciation or long-term debt).
- The accountant may 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.
- If GAAP sets forth requirements that apply to the presentation of financial statements, cash, modified cash, and income tax basis statements ordinarily should either comply with those requirements or provide information that communicates the substance of those requirements.

.08 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.

Cash Basis of Accounting

Pure Cash Basis

.09 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.

.10 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

.11 The modified cash basis of accounting is described as the pure cash basis incorporating modifications having substantial support. These modifications generally include the recognition of certain transactions having substantial support, such as recording depreciation on fixed assets or accruing income taxes, as entities would recognize them under GAAP. The appropriate modifications and the extent of those modifications are not clearly defined in the literature, however.

.12 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 (for example, 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

.13 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.

.14 Typically, entities that use the tax basis of accounting are one of the following:

- 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 No. 116, *Accounting for Contributions Received and Contributions Made,* and No. 117, *Financial Statements of Not-for-Profit Organizations.*

Nontaxed Entities

.15 The income tax basis of accounting is defined as the basis an entity uses or expects to use to file its income tax return. There is not any additional guidance on what is meant by the phrase *income tax return*. If taken literally, nontaxed-entities would not be able to use the income tax basis. However, many practitioners believe that not-for-profit organizations using the accounting principles followed in filing Form 990 may issue income tax basis financial statements.

Other Bases of Accounting

.16 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, entities generally may 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

.17 AR section 100A states that when the accountant reports on compiled financial statements that omit substantially all disclosures, he or she should disclose the basis of accounting in the compilation report if it is not disclosed in the financial statements.

Other Disclosures

.18 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

.19 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. Because financial statements prepared using an OCBOA contain modified titles (for example, "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 (for example, "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, paragraph .18 of AR section 100A states that the basis of accounting should be disclosed. 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, the basis should be disclosed in the accountant's report.

.20 When financial statements that the accountant has compiled omit substantially all disclosures with no reference to basis, but are otherwise in conformity with an OCBOA, the following form of standard report is appropriate. For illustrative purposes, the example is of a compilation of income tax basis financial statements.

> 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

.21 One of the major complications of prescribed form engagements has been the requirement in AR section 100A that the accountant's report disclose all material measurement departures from GAAP. In 1981, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AICPA, *Professional Standards*, vol. 2, AR sec. 300A), which amends AR section 100A and AR section 200A, *Reporting on Comparative Financial Statements* (AICPA, *Professional Standards*, vol. 2) to provide for an alternative form of standard compilation report when the prescribed form or related instructions call for departures from GAAP.

Provisions of AR Section 300A

.22 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.

.23 According to paragraph .03 of AR section 300A, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AICPA, *Professional Standards*, vol. 2), 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.

.24 Note that the first two paragraphs are similar to the standard compilation report of AR section 100A. The main differences are the references to the following:

- 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

.25 The accountant is concerned with the following 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 AR section 300A report.
- Departures from GAAP not required by the prescribed form. Such departures should be disclosed following the guidance in AR section 100A.
- Departures from the requirements of the prescribed form. These departures also should be disclosed following the guidance in AR section 100A.

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

Signing a Preprinted Report Form

.27 Paragraph .05 of AR section 300A states that the accountant should not sign a preprinted report form unless the language in it conforms to the guidance in AR section 300A or AR section 100A. 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 AR Section 300A Is Applicable

.28 Questions involving the applicability of AR section 300A 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.

.29 Does AR section 300A establish different standards for compiling a prescribed form? No. The reporting standards of AR section 100A require issuing a report whenever the accountant compiles or reviews financial statements included in a prescribed form. AR section 300A 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 AR section 100A.

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

.31 Is a tax return a prescribed form? No. AR section 300A refers to financial statements, and thus excludes financial presentations included in tax returns. Interpretation No. 10, "Reporting on Tax Returns" of AR section 100A (AICPA, *Professional Standards*, vol. 2, AR sec. 9100 par. .31–.32) points out that an accountant may attach a report to tax or information returns. This report should follow the guidance in AR section 100A because the tax return will be submitted to a user that did not design the form.

.32 Does a comprehensive set of instructions constitute a prescribed form? No. The definition of a prescribed form in AR section 300A specifically includes the words *standard preprinted form*.

.33 Is AR section 300A 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 AR section 300A alternative report is not appropriate.

.34 How does a prescribed form call for departures from GAAP? AR section 300A indicates that a form calls for a departure from GAAP by either:

- specifying a measurement principle not in conformity with GAAP; or
- sailing to request disclosures required by GAAP.

.35 Can an AR section 100A report be issued even if AR section 300A applies? Yes. The accountant should, however, comply with AR section 100A regarding departures from GAAP.

.36 Is the AR section 300A report appropriate when a prescribed form is presented to other third parties? No. The AR section 300A 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.

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

.38 What if the CPA is not independent? An accountant who is not independent can issue an AR section 300A report on financial statements included in a prescribed form. He or she should, however, comply with AR section 100A and include the following as the last paragraph of the report:

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

.39 Does the CPA have to mark each page of the prescribed form with "See Accountant's Report"? Yes. AR section 300A does not change that requirement.

Personal Financial Statements

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

.41 AICPA Statement of Position (SOP) 82-1, *Accounting and Financial Reporting for Personal Financial Statements* (AICPA, *Technical Practice Aids*, ACC sec. 10,350), 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

.42 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

.43 Before accepting the engagement, the accountant typically considers his independence, the client's integrity, and circumstances that present unusual business risks.

.44 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

.45 Both AR section 100A 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 because the cooperation of the client is vital to developing adequate accounting information.

Client Representation Letters

.46 Although AR section 100A 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 of the following:

- 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

.47 Standards for compilation of financial statements prescribed by AR section 100A 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.

.48 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.

.49 Second, the accountant ordinarily should posses a general understanding of the following:

- 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

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

.51 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.

.52 However, the *Personal Financial Statements Guide* warns that other factors may prevent the acceptance of the client's estimate. The guide states that, at a minimum, the accountant should 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.

.53 With the exception of compiled personal financial statements that omit substantially all disclosures, the financial statements, including the notes, ordinarily 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.

.54 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 ordinarily should obtain the individual's approval and acceptance of responsibility for the values, preferably in writing.

Review of Personal Financial Statements

.55 Standards for the review of financial statements prescribed by AR section 100A 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 should meet the following general requirements.

.56 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.

.57 AR section 100A requires accountants to obtain a representation letter in all review engagements.

Reporting

.58 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.

.59 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.

.60 In addition, if substantially all disclosures have been omitted, the accountant should 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

.61 Paragraph .03 of AR section 600, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (AICPA, *Professional Standards*, vol. 2), provides an exemption from AR section 100A 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.

.62 If both conditions exist, the accountant is exempt from both the performance and reporting standards in AR section 100A. Absent both of these conditions, AR section 100A would apply.

.63 As long as those same conditions are met, Interpretation No. 1, "Submitting a Personal Financial Plan to a Client's Advisers" of AR section 600 (AICPA, *Professional Standards*, vol. 2, AR sec. 9600 par. .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

.64 AR section 600 prescribes the following language when the conditions of the AR section 100A 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.

.65 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

.66 A compilation of one or more specified elements, accounts, or items of a financial statement is limited to presenting financial information that is the representation of management (owners) without undertaking to express any assurance on that information. (The accountant might consider it necessary to perform other accounting services to compile the financial information.)

.67 Examples of specified elements, accounts, or items of a financial statement that an accountant may compile include schedules of rentals, royalties, profit participation, or provision for income taxes.

.68 In accordance with paragraph .04 of AR section 110, *Compilation of Specified Elements, Accounts, or Items of a Financial Statement* (AICPA, *Professional Standards*, vol. 2), if an accountant prepares or assists a client in preparing a schedule of one or more specified elements, accounts, or items of a financial statement, the accountant should consider how such a presentation of specified elements, accounts, or items will be used. If the specified element, account, or item of a financial statement is included as accompanying information to the basic financial statements, the accountant must consider the guidance in paragraph .70 of AR section 100A. The accountant should also consider the potential of being associated with the schedule and the likelihood that the user may inappropriately infer, through that association, an unintended level of assurance. If the accountant believes that he or she will be associated with the information, the accountant should consider issuing a compilation report so a user will not infer a level of assurance that does not exist.

.69 An engagement to compile one or more specified elements, accounts, or items of a financial statement may be undertaken as a separate engagement or in conjunction with a compilation of financial statements.

.70 Before issuance of a compilation report on one or more specified elements, accounts, or items of a financial statement, the accountant should read such compiled specified elements, accounts, or items of a financial statement and consider whether the information appears to be appropriate in form and free of obvious material errors. In this context, the term *error* refers to mistakes in the compilation of the specified elements, accounts, or items of a financial statement, including arithmetical or clerical mistakes, and mistakes in the application of accounting principles, including disclosures, if presented.

.71 When the accountant is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement, the basic elements of the report, in addition to the basic elements described in paragraph .05 of AAM section 2600, *Reporting*, are as follows:

a. A statement that the specified element(s), account(s), or item(s) identified in the report were compiled. If the compilation was performed in conjunction with a compilation of the company's financial statements, the paragraph should so state and indicate the date of the accountant's compilation report on those financial statements. Furthermore, any departure from the standard report on those statements should also be disclosed if considered relevant to the presentation of the specified element(s), account(s), or item(s).

b. A description of the basis on which the specified element(s), account(s), or item(s) are presented if that basis is not generally accepted accounting principles and a statement that that basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles.

.72 Each page of the compiled specified elements, accounts, or items of a financial statement should include a reference, such as "See Accountant's Compilation Report."

.73 Following are illustrations of accountant's compilation reports on specified elements, accounts, or items of a financial statement.

Report Related to Accounts Receivable

I (we) have compiled the accompanying schedule of accounts receivable of XYZ Company as of December 31, 20X6, 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 financial information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying schedule of accounts receivable and, accordingly, do not express an opinion or any other form of assurance on it.

Report Related to the Schedule of Depreciation— Income Tax Basis

I (we) have compiled the accompanying schedule of depreciation—income tax basis of XYZ Company as of December 31, 20X6, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The schedule of depreciation—income tax basis has been prepared on the accounting basis used by the company for federal income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

A compilation is limited to presenting financial information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying schedule of depreciation—income tax basis and, accordingly, do not express an opinion or any other form of assurance on it.

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

.74 Paragraphs .80–.82 of AR section 100A states that an accountant is responsible for compliance with SSARS in a review or compilation engagement. Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01) of the Code of Professional Conduct of the AICPA requires members to comply with such standards when associated with reviewed or compiled financial statements.

.75 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.

.76 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 SSARSs.

[*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 December 31, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .14 of AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2)]

* In February 2008, the Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services (SSARS) No. 17, *Omnibus Statement on Standards for Accounting and Review Services—2008* (AICPA, *Professional Standards*, vol. 2), which amends some of the guidance for compilation and review engagements. SSARS No. 17 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2008, with early application permitted. This manual will be updated for SSARS No. 17 in the next edition.

Due to the issuance of SSARS No. 17, AR sections 100, 9100, 200, 300, 9300, and 400 have been moved to AR sections 100A, 9100A, 200A, 300A, 9300A, and 400A, respectively, of *Professional Standards* until the effective date of SSARS No. 17. This manual references the "A" sections as appropriate because SSARS No. 17 has not been incorporated in this edition.

.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 December 31, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .20 of AR section 100A]

.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 December 31, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .14 of AR section 100A]

.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 December 31, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .20 of AR section 100A]

.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 December 31, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .45 of AR section 100A]

.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 December 31, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .45 of AR section 100A]

.07 Financial Statements Included in Certain Prescribed Forms

[*Name*], President
[*Company*]
[*Address*]

We have compiled the accompanying balance sheet of [*Company*] as of December 31, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .03 of AR section 300A, *Compilation Reports on Financial Statement Included in Certain Prescribed Forms* (AICPA, *Professional Standards*, vol. 2)]

.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 December 31, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .04 of AR section 300A]

.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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .14 of AR section 100A]

.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, 20X6, 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, 20X7

[*Signature of CPA*]

[Source: Derived from paragraph .47 of AR section 100A]

[*The next page is 3001.*]

AAM Section 3000 Engagement Planning and Administration

Sections 3160 and 3165 include illustrative audit assignment control forms and engagement letters that can be used by an accountant in the planning phase of an audit engagement.

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

Illustrative formats of audit assignment controls and engagement letters 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.

References to Professional Standards. When referring to the professional standards, this manual cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*. All references to AU sections may be found in AICPA *Professional Standards*, volume 1.

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AAM Section 3100

Planning the Engagement

General

.01 The planning phase is an important part of every engagement. During this phase, the partner and the staff obtain an understanding of the entity and its environment, including its internal control, 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* (AICPA, *Professional Standards*, vol. 1, ET sec. 201 par. .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 (GAAS) states: "The auditor must adequately plan the work and must properly supervise any assistants." AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance to the independent auditor conducting an audit in accordance with GAAS on the considerations and activities applicable to planning and supervision.

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

.05 The nature, timing, and extent of planning vary with the size and complexity of the entity and with the auditor's experience with the entity and understanding of the entity and its environment, including its internal control. The auditor must plan the audit so that it is responsive to the assessment of the risk of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control (see AAM sections 3120 and 3125).

Audit Planning

.06 Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion. As a result of performing planned audit procedures,[1] the auditor may obtain disconfirming evidence that might cause the auditor to revise the overall audit strategy.

Appointment of the Independent Auditor

.07 Early appointment of the independent auditor has many advantages to both the auditor and the client. Early appointment enables the auditor to plan the audit prior to the balance-sheet date. Although early appointment is preferable, an independent auditor may accept an engagement near or after the close of the fiscal year. In such instances, before accepting the engagement, the auditor should ascertain whether circumstances are likely to permit an adequate audit and expression of an unqualified opinion and, if they will not, the auditor should discuss with the client the possible necessity for a qualified opinion or disclaimer of opinion.

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[1] Paragraph .03 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), provides guidance with respect to the procedures the auditor performs in obtaining an understanding of the entity and its environment to establish a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing the risks of material misstatement of the financial statements.

Establishing an Understanding With the Client and Preparing an Engagement Letter

.08 The auditor should establish an understanding with the client regarding the services to be performed for each 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.

.09 AU section 311 states that the auditor should document the understanding through a written communication with the client in the form of an engagement letter. 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 generally describes 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*. It is necessary for the members of the staff working on the engagement to 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.

.10 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.

.11 If the auditor has reason to believe the client may publish all or a portion of an audit report, he may 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.

.12 Generally, the auditor establishes the understanding with the client and prepares the engagement letter before any significant work takes place on the engagement. The partner may 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 may 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. It is a best practice to always make sure that a final engagement letter is issued in such circumstances.

.13 If the nature of an engagement changes during its progress, or if the firm is engaged for additional services during the year, a new engagement letter is generally prepared. A step-down to a compilation or review engagement, or a special engagement for preparing a forecast, are examples of changes that could necessitate a new engagement letter. Such changes are ordinarily 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

.14 The following matters may be considered 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. (AU section 508, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*, vol. 1]).
  - — 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

.15 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 and the selection and application of the accounting policies.
- Management is responsible for establishing and maintaining effective internal control over financial reporting.
- Management is responsible for designing and implementing programs and controls to prevent and detect fraud.
- Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
- Management is responsible for making all financial records and related information available to the 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 GAAS. 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 the entity and its environment, including its internal control, sufficient to assess the risks of material misstatement of the financial statements and to design the nature, timing, and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify significant deficiencies. However, the auditor is responsible for ensuring that those charged with governance are aware of any significant deficiencies that 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.

.16 The engagement letter is generally addressed to those charged with governance, the chief executive, or whoever retained the firm. The engagement partner may sign the letter on behalf of the firm. The client representative responsible for the engagement signs the letter denoting agreement with the contract. The original letter may be maintained in the engagement documentation. A copy of the letter is given to the client.

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

- The overall audit strategy.
- Involvement of specialists or internal auditors, if applicable.
- Involvement of a predecessor auditor.
- Fees and billing. Estimates of fees are usually based on conservative, carefully prepared estimates. It may be useful to describe the expected billing methods and payment periods.
- 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, such as 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.
- Other services to be provided in connection with the engagement, for example, nonattest services, such as accounting assistance and preparation of tax returns subject to the limitations of Ethics Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05).

.18 The following 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 is usually 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, 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.

.19 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 an understanding 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

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

.21 Under the Fair Credit Reporting Act, an individual is 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 is also 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

.22 See AAM section 3165 for sample engagement letters.

Preliminary Engagement Activities

.23 In addition to the procedures mentioned previously, at the beginning of the audit engagement the auditor should (1) perform procedures regarding the continuance of the client relationship and the specific audit engagement and (2) evaluate the auditor's compliance with ethical requirements, including independence. The purpose of performing these preliminary engagement activities is to consider any events or circumstances that may either adversely affect the auditor's ability to plan and perform the audit engagement to reduce audit risk to an acceptably low level or may pose an unacceptable level of risk to the auditor.

The Overall Audit Strategy

.24 In establishing the overall audit strategy, the auditor should (1) determine the characteristics of the engagement that define its scope, such as the basis of reporting, industry specific reporting requirements, and the locations of the entity; (2) ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required, such as deadlines for interim and final reporting, and key dates for expected communications with management and those charged with governance; and (3) consider the important factors that will determine the focus of the audit team's efforts, such as determination of appropriate materiality levels, preliminary identification of areas where there may be higher risks of material misstatement, preliminary identification of material locations and account balances, evaluation of whether the auditor may plan to obtain evidence regarding the operating effectiveness of internal control, and identification of recent significant entity specific, industry, financial reporting, or other relevant developments. The appendix to AU section 311 provides examples of matters the auditor may consider in establishing the overall audit strategy.

The Audit Plan

.25 The auditor must develop an audit plan in which the auditor documents the audit procedures to be used that, when performed, are expected to reduce audit risk to an acceptably low level. The audit plan is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Documentation of the audit plan also serves as a record of the proper planning and performance of the audit procedures that can be reviewed and approved prior to the performance of further audit procedures. The audit plan should include the following:

- A description of the nature, timing, and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement, as determined under AU section 314, *Understanding the*

Entity and Its Environment and Assessing the Risks of Material Misstatement (AICPA, *Professional Standards*, vol. 1).

- A description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level for each material class of transactions, account balance, and disclosure, as determined under AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1). The plan for further audit procedures reflects the auditor's decision whether to test the operating effectiveness of controls and the nature, timing, and extent of planned substantive procedures.
- A description of other audit procedures to be carried out for the engagement in order to comply with GAAS (for example, seeking direct communication with the entity's lawyers).

Determining the Extent of Involvement of Professionals Possessing Specialized Skills

.26 The auditor should consider whether specialized skills are needed in performing the audit. 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 determine whether that professional will effectively function as a member of the audit team. If such a professional is part of the audit team, the auditor's responsibilities for supervising that professional are equivalent to those for other assistants. In such circumstances, the auditor should have sufficient knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified audit procedures will meet the auditor's objectives; and to evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of further planned audit procedures.

Communications With Those Charged With Governance and Management

.27 Paragraph .23 of AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), explains that, among other matters, the auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit.

Additional Considerations in Initial Audit Engagements

.28 Before starting an initial audit, the auditor should perform procedures regarding the acceptance of the client relationship and the specific audit engagement (see Statement on Quality Control Standards No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, as amended [AICPA, *Professional Standards*, vol. 2, QC sec. 20]) and communicate with the previous auditor, where there has been a change of auditors (see AU section 315, *Communication Between Predecessor and Successor Auditors* [AICPA, *Professional Standards*, vol. 1]). The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not have the previous experience with the entity that is considered when planning recurring engagements. See paragraph .27 of AU section 311 for additional matters the auditor should consider in developing the overall audit strategy and audit plan for an initial audit.

[*The next page is 3121.*]

AAM Section 3105

Understanding the Assignment

.01 The auditor may (*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.

.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 and must be followed.

.03 AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1),[*] sets forth the GAAP hierarchy.

.04 AU section 411

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 following table 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.

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[*] In April 2005, the Financial Accounting Standards Board (FASB) issued an exposure draft of a proposed FASB statement, *The Hierarchy of Generally Accepted Accounting Principles*, objectives of which include moving responsibility for the generally accepted accounting principles (GAAP) hierarchy for nongovernmental entities from the AICPA AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1), to FASB literature. The FASB then issued a revised exposure draft during the third quarter of 2006. The proposed FASB statement expands the sources of category *a* of the hierarchy of GAAP to include accounting principles that are issued after being subject to the FASB's due process (including, but not limited to, FASB Staff Positions and FASB Statement No. 133, *Implementation Issues*, which are currently not addressed in AU section 411).

Among other matters, the proposed FASB statement would not carry forward the Rule 203 exception from paragraph .07 of AU section 411. Accordingly, the proposed FASB statement states that an enterprise shall not represent that its financial statements are presented in accordance with GAAP if its selection of accounting principles departs from the GAAP hierarchy set forth in this FASB statement and that departure has a material impact on its financial statements.

In response to the proposed FASB statement in May 2005, the AICPA issued an exposure draft of a proposed Statement on Auditing Standards (SAS), *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities for Nongovernmental Entities*, which deletes the GAAP hierarchy for nongovernmental entities from AU section 411. The Public Company Accounting Oversight Board (PCAOB) has already taken measures to remove the GAAP hierarchy from its interim auditing standards in a set of amendments that adopted on January 29, 2008. The amendments, if approved by the Securities and Exchange Commission (SEC), will become effective 60 days after SEC approval. For more information, please visit the FASB Web site at www.fasb.org and the PCAOB Web site at www.pcaob.org.

.06 GAAP Hierarchy Summary*

Nongovernmental Entities	*State and Local Governments*	*Federal Governmental Entities*
	Established Accounting Principles	
.10*a* Financial Accoutning Standards Board (FASB) statements and interpretations, Accounting Principles Board (APB) opinions, and AICPA Accounting Research Bulletins	.12*a* Governmental Accounting Standards Board (GASB) statements and interpretations, plus AICPA and FASB pronouncements if made applicable to state and local governments by a GASB statement or interpretation	.14*a* Federal Accounting Standards Advisory Board (FASAB) statements and interpretations plus AICPA and FASB pronouncements if made applicable to federal governmental entities by a FASAB statement or interpretation
.10*b* FASB technical bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position	.12*b* GASB technical bulletins, and the following pronouncements if specifically made applicable to state and local governments by the AICPA: AICPA Industry Audit and Accounting Guides and AICPA Statements of Position	.14*b* 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
.10*c* Consensus positions of the FASB Emerging Issues Task Force and AICPA Practice Bulletins	.12*c* Consensus positions of the GASB Emerging Issues Task Force† and AICPA Practice Bulletins if specifically made applicable to state and local governments by the AICPA	.14*c* AICPA Accounting Standards Executive Committee 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
.10*d* AICPA accounting interpretations, "Qs and As" published by the FASB staff, as well as industry practices widely recognized and prevalent	.12*d* "Qs and As" published by the GASB staff, as well as industry practices widely recognized and prevalent	.14*d* Implementation guides published by the FASAB staff and practices that are widely recognized and prevalent in the federal government

Nongovernmental Entities	*State and Local Governments*	*Federal Governmental Entities*
	Other Accounting Literature‡	
.11 Other accounting literature, including FASB concepts statements; AICPA issues papers; International Accounting Standards Committee statements; GASB statements, interpretations, and technical bulletins; FASAB statements, interpretations, and technical bulletins; pronouncements of other professional associations or regulatory agencies; AICPA *Technical Practice Aids*, and accounting textbooks, handbooks, and articles	.13 Other accounting literature, including GASB concepts statements; pronouncements in categories (*a*)–(*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 *Technical Practice Aids*; and accounting textbooks, handbooks, and articles	.15 Other accounting literature, including FASAB concepts statements; pronouncements in categories (*a*)–(*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 *Technical Practice Aids*; and accounting textbooks, handbooks, and articles

* Paragraph references correspond to the paragraphs of AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1), that describe the categories of the GAAP hierarchy.

† As of the date of this manual, the GASB had not organized such a group.

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

Practice Tip

On January 15, 2008, the FASB launched the one year verification phase of the *FASB Accounting Standards Codification*™ (codification). After the verification period, during which constituents are encouraged to provide feedback on whether the codification content accurately reflects existing U.S. GAAP for nongovernmental entities, the FASB is expected to formally approve the codification as the single source of authoritative U.S. GAAP, other than guidance issued by the Securities and Exchange Commission (SEC). The codification includes all accounting standards issued by a standard-setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, EITF, and related literature. The codification does not change GAAP; instead it reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics, and displays all topics using a consistent structure. The SEC guidance will follow a similar topical structure in separate SEC sections.

This edition of the Audit and Accounting Manual (AAM) has not been conformed to the new codification. The AICPA AAM, as well as other AICPA literature, will be conformed to reflect the codification after the verification phase and upon formal approval by the FASB.

Generally Accepted Auditing Standards

.07 An independent auditor plans, conducts, and reports the results of an audit in accordance with 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 AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), provides a framework of GAAS.

.09 The general, field work, and reporting standards (the 10 standards) are as follows:

General Standards

1. The auditor must have adequate technical training and proficiency to perform the audit.
2. The auditor must maintain independence in mental attitude in all matters relating to the audit.
3. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.

Standards of Fieldwork

1. The auditor must adequately plan the work and must properly supervise any assistants.
2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.
3. The auditor must obtain sufficient appropriate[1] audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting[2]

1. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).[3]

[1] See paragraph .06 of AU section 325, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), for the definition of the term *appropriate*.

[2] The reporting standards apply only when the auditor issues a report.

[3] When an auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the first standard of reporting is satisfied by stating in the auditor's report that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles and by expressing an opinion (or disclaiming an opinion) on whether the financial statements are presented in conformity with the comprehensive basis of accounting used.

2. The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.

4. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.

.10 Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .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 Auditing Standards Board (ASB). The ASB develops and issues standards in the form of Statements on Auditing Standards (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.[4] The auditor should be prepared to justify departures from the SASs. When, in rare circumstances, the auditor departs from a presumptively mandatory requirement, the auditor must document in the working papers his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement.

.12 *Interpretive publications* consist of auditing interpretations of the SASs, appendixes to the SASs,[5] 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 the following:

- AICPA auditing publications not referred to previously
- 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.

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[4] See AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1).

[5] Appendixes to the SASs referred to in paragraph .05 of AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1), do not include previously issued appendixes to original pronouncements that when adopted modified other SASs.

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.

[*The next page is 3141.*]

AAM Section 3110

Assigning Personnel to the Engagement and Supervision

General Comments

.01 Engagement planning includes procedures for assigning personnel to the engagement. Having procedures established provides 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 guidance for assigning personnel to engagements is addressed in the *Practice Aid for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Revised for the Issuance of Statement on Quality Control Standards No. 7,* A Firm's System of Quality Control in AAM section 10,200. Sample quality control forms are available at AAM section 10,300, which are helpful in assigning personnel to engagements.

Engagement Planning Procedures

.03 A time budget for the engagement is prepared to determine manpower requirements and to schedule field work. The engagement partner typically approves the time budget prior to the beginning of field work. A time budget may 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 paragraph .01 of AAM section 3160 for "Audit Time Budget—Sample A"), whereas others combine these reports into one form (see paragraph .02 of AAM section 3160 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, 100 hours; see paragraph .03 of AAM section 3160 for "Audit Time Analysis—Short Form") and a longer form for jobs requiring more time (see paragraph .04 of AAM section 3160 for "Audit Time Analysis—Long Form"). Some firms use a weekly (or daily) progress report (see paragraph .05 of AAM section 3160, 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 is usually 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 because it is applied so that it can be compared to the budgeted time for that phase of the engagement.

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

a. Engagement size and complexity

b. Personnel availability

c. Special expertise

d. Timing of the work to be performed

e. Continuity and periodic rotation of personnel

f. Opportunities for on-the-job training

.07 The scheduling and staffing of the engagement is typically 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 is usually considered in relation to the complexity or other requirements of the engagement and the extent of supervision to be provided.

.08 It is recommended that all procedures discussed in this section be documented in the accountant's working papers.

Supervision

.09 Supervision involves directing the efforts of assistants who are involved in accomplishing the objectives of the audit and determining whether those objectives were accomplished. Elements of supervision include instructing assistants, keeping informed of significant issues encountered, reviewing the work performed, and dealing with differences of opinion among firm personnel. The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work, including knowledge of the client's business and industry.

.10 The auditor with final responsibility for the audit should communicate with members of the audit team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud, with special emphasis on fraud. Such discussion helps all audit team members understand the entity and its environment, including its internal control, and how risks that the entity faces may affect the audit. The discussion should emphasize the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating evidence throughout the audit.[1]

.11 In addition, assistants should be informed of their responsibilities and the objectives of the audit procedures they are to perform. They should be informed of matters that may affect the nature, timing, and extent of audit procedures they are to perform, such as the nature of the entity's business as it relates to their assignments and possible accounting and auditing issues. The auditor with final responsibility for the audit should direct assistants to bring to his or her attention accounting and auditing issues raised during the audit that the assistant believes are of significance to the financial statements or auditor's report so the auditor with final responsibility may assess their significance. Assistants also should be directed to bring to the attention of appropriate individuals in the firm difficulties encountered in performing the audit, such as missing documents or resistance from client personnel in providing access to information or in responding to inquiries.

.12 The work performed by each assistant, including the audit documentation, should be reviewed to determine whether it was adequately performed and documented and to evaluate the results, relative to the conclusions to be presented in the auditor's report.

[1] For further guidance on the discussion among the audit team, see paragraphs .14–.18 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), and paragraphs .14–.20 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1).

.13 Each assistant has a professional responsibility to bring to the attention of appropriate individuals in the firm disagreements or concerns with respect to accounting and auditing issues that the assistant believes are of significance to the financial statements or auditor's report, however those disagreements or concerns may have arisen. The auditor with final responsibility for the audit and assistants should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel involved in the audit. Such procedures should enable an assistant to document his or her disagreement with the conclusions reached if, after appropriate consultation, he or she believes it necessary to disassociate himself or herself from the resolution of the matter. In this situation, the basis for the final resolution should also be documented.

[*The next page is 3161.*]

AAM Section 3115

Independence

General Comments

.01 In accordance with Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .01), of the AICPA Code of Professional Conduct, a member in public practice shall be independent in the performance of professional services, which includes 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, and
- 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* states that the auditor must maintain independence in mental attitude in all matters relating to the audit; therefore, 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 financial statements—does not require independence. If a nonindependent firm issues a compilation report, the following should be included as the last paragraph of the report, "I am (we are) not independent with respect to XYZ Company."[2]

.04 Engagement planning includes procedures to provide the firm with reasonable assurance that all persons required to 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 [SEC], and the Department of Labor [DOL]), do so. The interpretations and rulings under Rule 101 of the AICPA Code of Professional Conduct contain examples of instances wherein a firm's independence will be considered to be impaired.

.05 As stated in the following text, audit firms that perform audits of or perform other attest services for public companies or other SEC registrants should consult the independence rules of the SEC and the Public Company Accounting Oversight Board (PCAOB).

.06 Other organizations that have established other independence requirements that a member should consult if applicable include the following:

- State boards of accountancy
- State CPA societies
- Federal and state agencies, such as the Governmental Accountability Office (GAO)

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[1] There are additional requirements for public companies and companies subject to other governmental oversight.

[2] Paragraph .19 of AR section 100A, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2).

.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. The AICPA's Practice Aids, *Independence Compliance—Checklists and Tools for Complying With AICPA and GAO Independence Requirements* (product no. 006627), and *Independence Compliance: Checklists and Tools for Complying with AICPA, SEC, and PCAOB Independence Requirements* (product no. 006630), are valuable resources for helping practitioners observe applicable independence rules. The practice aids can be obtained at www.cpa2biz.com or by calling (888) 777-7077.

Maintaining Your Independence

.08 Maintaining your independence is your responsibility, not your firm's. As part of its quality control system, the firm is often 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, a good, working understanding of the basic independence rules is essential. At a minimum, it is important to be aware of the circumstances in which you and your immediate family meet the definition of a covered member (discussed in the following section in greater detail) 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 may consult with someone in your firm who is knowledgeable about such matters, or you may seek the advice of the AICPA (ethics@aicpa.org). If your firm performs audits and other attest services for SEC registrants, you should also familiarize yourself with rules promulgated by the SEC and the PCAOB.

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). According to paragraph .06 of ET section 92, *Definitions*, (AICPA, *Professional Standards*, vol. 1), 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)–(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 associated with an attest client during the period covered by the financial statements or during the period of the professional engagement as a
  - — director, officer (or any management capacity), or employee,
  - — promoter, underwriter, or voting trustee, or
  - — trustee of any of the client's employee benefit plans.
- No partner or professional employee, his or her immediate family, or any group of such persons acting together 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* as defined in ET section 92.

.13 If you are a covered member with respect to a client, members of your immediate family (your spouse, spousal equivalent, or dependents [whether related or not]) should follow the same rules as you. So, for example, your spouse's investments should 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
   - has the ability to exercise influence over the contents of the financial statements, including when the individual is a member of the board of directors or similar governing body, CEO, president, CFO, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.
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 ten or more hours of nonattest services to the client; and
   - partners who are 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 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, and

- any partners in the office where the client's lead partner the attest engagement.

.17 Close relatives are your

- nondependent children,
- siblings, or
- parents.

.18 So, as a covered member, your close relative's employment by a client would impair independence if your relative had a key position with the client.

.19 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 and of which you have knowledge 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 of which you or the partner have knowledge and
  - — enables your relative to exercise significant influence over the client.

Financial Relationships

.20 There are various types of financial interests and some of those interests affect independence. Although your firm and its employee benefit plans are 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.

.21 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.

.22 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. For example, if you sign a stock subscription agreement with the client, your independence would be considered impaired as soon as you sign the agreement.

.23 According to paragraph .17 of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2), a financial interest is an ownership interest in an equity or a debt security issued by an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest. Examples of financial interests may 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.

.24 Direct financial interests are financial interests that are owned by you directly; under your control; or beneficially owned by you through an investment vehicle, estate, trust, or other intermediary if you (*a*) control the intermediary; or (*b*) have the authority to supervise or participate in the intermediary's investment decisions.

For example, if you invest in a participant directed 401(k) plan, whereby you are able to select the investments held in your account or are able to select from investment alternatives offered by the plan, you would be considered to have a direct financial interest in the investments held in your account.

.25 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.
- Section 529 savings plan, if you are the account owner.
- estate, if you serve as an executor and meet certain other criteria.
- trust, if you serve as the trustee and meet certain other criteria.

.26 Indirect financial interests arise if you have a financial interest that is beneficially owned through an investment vehicle, estate, trust, or other intermediary when you can neither control the intermediary nor have the authority to supervise or participate in the intermediary's investment decisions. For example, if you invest in a defined contribution plan that is not participant directed and you have no authority to supervise or participate in the plan's investment decisions, you would be considered to have an indirect financial interest in the underlying plan investments.

Business Relationships

.27 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 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.

.28 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.

.29 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.

.30 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 hold such position with a client 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 may 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

.31 Two types of fee arrangements, contingent fees and commissions, are prohibited when the arrangement involves certain attest clients (see paragraph .36 for details), even though the fee is not related to an attest service.

.32 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 as follows:

- 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 as follows:

- 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

.33 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. Permitted commissions shall be disclosed to the person or entity you recommend or refer a product or service to.

.34 Examples of commissions are if 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.

.35 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. You must inform the client if you receive or pay a referral fee.

.36 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

.37 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.

Restricted Entities

.38 Be familiar with the firm's restricted entities. Restricted entities are those entities for whom the firm provides attest services. 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.

.39 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.

.40 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 may 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 or refinancing an existing loan.
- having an immediate family member change employers or assume new responsibilities at an existing job.

Nonattest Services

.41 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 Interpretation 101-3, "Performance of nonattest services" of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05) establishes standards and provides guidance regarding the performance of nonattest services. Interpretation No. 101-3 discusses the services that are permitted and prohibited under the ruling, as well as the member's 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 GAO) may have more restrictive rules concerning nonattest services, which should be reviewed depending upon the circumstances of the engagement.

.42 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 as follows:

- Bookkeeping services
- Payroll and other disbursement services
- Internal audit assistance
- Benefit plan administration
- Investment advisory or management services
- Tax compliance services

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[3] Also see AICPA Ethics Ruling No. 25, "Commission and Contingent Fee Arrangements With Nonattest Client" of ET section 391, *Ethics Rulings on Responsibilities to Clients* (AICPA, *Professional Standards*, vol. 2, ET sec. 391 par. .049–.050) of the Code of Professional Conduct.

[4] Defined in the Code of Professional Conduct, an *attest engagement* is one that requires independence under AICPA *Professional Standards*; for example, audits and reviews of financial statements or agreed upon procedures performed under the attestation standards.

- Forensic accounting 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

.43 Interpretation No. 101-3 lists three general requirements in order to maintain independence when performing permitted nonattest services.

.44 The first of the three general requirements of Interpretation No. 101-3 states that a member should not perform management functions or make management decisions for an attest client. (However, the member may provide advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions.)

.45 The second general requirement is that the client must agree to perform the following functions in connection with the engagement:

- Make all management decisions and perform all management functions
- Designate an individual who possesses suitable skill, knowledge, experience, or any combination of these, preferably within senior management, to oversee the services
- Evaluate the adequacy and results of the services performed
- Accept responsibility for the results of the services

The member should be satisfied that the client will be able to meet all of these criteria and to make an informed judgment on the results of the member's nonattest services. In assessing whether the designated individual possesses suitable skill, knowledge, and experience, the member should be satisfied that the employee understands the services to be performed sufficiently to oversee them. However, the individual is not required to possess the expertise to perform or reperform the services. In cases where the client is unable or unwilling to assume these responsibilities (for example, the client does not have an individual with the necessary competence to oversee the nonattest services provided, or is unwilling to perform such functions due to lack of time or desire), the member's provision of nonattest services would impair independence.

.46 The third general requirement is that before performing nonattest services, the member should establish and document in writing his or her understanding with the client (board of directors, audit committee, or management, as appropriate in the circumstances) regarding the following:

a. Objectives of the engagement

b. Services to be performed

c. Client's acceptance of its responsibilities

d. Member's responsibilities

e. Any limitations of the engagement

The understanding might be documented in a separate engagement letter, in the working papers, or in an internal memo, or it might be included in an engagement letter obtained in conjunction with an attest engagement.

.47 The second and third general requirements do not apply to certain routine activities performed by the member such as assisting clients with technical accounting questions, advising on internal controls, or providing periodic training on new pronouncements that are part of the normal client-member relationship.

.48 One of the key principles underlying the AICPA rules on nonattest services is that 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.
- supervise client employees in the performance of their normal recurring activities.
- determine which recommendations of the member should be implemented.
- report to the board of directors on behalf of management.
- establish or maintain internal controls, including performing ongoing monitoring activities for a client.

.49 In addition, the following are examples of the types of activities that impair independence:

- Authorizing, executing, or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Serving as a client's stock transfer or escrow agent, registrar, general counsel, or its equivalent
- Designing a client's financial information system
- Performing a valuation of a client's business
- Establishing and maintaining internal controls, including performing ongoing monitoring activities for a client

.50 Additionally, Interpretation No. 101-3 requires you comply with more restrictive independence provisions, if applicable, of certain regulators such as state boards of accountancy, the SEC, and the GAO.

.51 *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.

.52 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. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, vol. 2, QC sec. 10).

Independence Quality Controls

.53 Paragraph .21 of SQCS No. 7 states that the firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel, and, where applicable, others subject to independence requirements, maintain independence where required. Independence requirements are set forth in ET section 101 and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Guidance on threats to independence, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time and safeguards to mitigate such threats involving matters that are not explicitly addressed in the Code of Professional Conduct are set forth in the AICPA's Conceptual Framework for AICPA Independence Standards. Such policies and procedures should enable the firm to *a.* communicate its independence requirements to its personnel and, where applicable, others subject to them.

b. identify and evaluate circumstances and relationships that create threats to independence and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safe guards, or, if effective safeguards cannot be applied, withdrawing from the engagement.

.54 Such policies and procedures should require

a. the engagement partner to consider relevant information about client engagements, including the scope of services, to enable him or her to evaluate the overall effect, if any, on independence requirements.

b. personnel to promptly notify the engagement partner and the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken.

c. the accumulation and communication of relevant information to appropriate personnel so that

1. the firm, the engagement partner, and other firm personnel can readily determine whether they satisfy independence requirements;
2. the firm can maintain and update information relating to independence; and
3. the firm and the engagement partner can take appropriate action regarding identified threats to independence.

.55 The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for

a. personnel to promptly notify the firm of independence breaches of which they become aware.

b. the firm to promptly communicate identified breaches of these policies and procedures and the required corrective actions to

1. the engagement partner who, with the firm, has the responsibility to address the breach; and
2. other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action.

c. confirmation to the firm by the engagement partner and the other individuals referred to in subparagraph (b[2]) that the required corrective actions have been taken.

.56 At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the requirements set forth in ET section 101 and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Written confirmation may be in paper or electronic form.

.57 The purpose of obtaining confirmation and taking appropriate action on information indicating noncompliance is to demonstrate the importance that the firm attaches to independence and keep the issue current for and visible to its personnel.

.58 For all audit or attestation engagements where regulatory or other authorities require the rotation of personnel after a specified period, the firm's policies and procedures should address these requirements.

Additional Guidance

.59 It is recommended that all procedures discussed in this section be documented in the auditor's working papers.

.60 For additional guidance practitioners may refer to AICPA *Independence and Ethics Alert* (AAM section 8240). This annual alert informs you of recent developments in the area of independence and ethics for accountants. Moreover, the alert helps you understand your independence requirements under the AICPA Code and, if applicable, certain other rule making and standard setting bodies. Also, the alert contains the AICPA Plain English Guide to Independence, which discusses the independence rules of the principal standard setting bodies in plain, straight forward English so you can understand and apply them with greater confidence and ease.

[*The next page is 3181.*]

AAM Section 3120

Understanding the Entity and Its Environment

General

.01 In accordance with the second standard of field work, "the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures." Obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with generally accepted auditing standards. In particular, that understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing risks of material misstatement of the financial statements and responding to those risks throughout the audit, for example, when

- establishing materiality for planning purposes and evaluating whether that judgment remains appropriate as the audit progresses;
- considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures;
- identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going-concern assumption, complex or unusual transactions, or considering the business purpose of transactions;
- developing expectations for use when performing analytical procedures;
- designing and performing further audit procedures to reduce audit risk to an appropriately low level; and
- evaluating the sufficiency and appropriateness of audit evidence obtained, such as evidence related to the reasonableness of management's assumptions and of management's oral and written representations.

.02 The auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures. The depth of the overall understanding that the auditor obtains in performing the audit is less than that possessed by management in managing the entity.

.03 Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Throughout this process, the auditor should also follow the guidance in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1).

Risk Assessment Procedures

.04 Audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels are referred to as *risk assessment procedures*. The auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels.

.05 The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

a. Inquiries of management and others within the entity

b. Analytical procedures

c. Observation and inspection

.06 Risk assessment procedures are designed to gather and evaluate information about the client and are not specifically designed as substantive procedures or as tests of controls. Nevertheless, in performing risk assessment procedures, the auditor may obtain evidence about relevant assertions or the effectiveness of controls.

Inquiry of Management and Others

.07 Although much of the information obtained by inquiry can be obtained from management, accounting personnel, and others involved in the financial reporting process, it is often helpful to direct inquiries to others within the entity. For example, people who work in production, sales, or internal audit, as well as individuals employed at different levels within the organization can provide a different perspective that helps identify risks of material misstatement. Inquiries of others can also help corroborate or provide additional details to the statements and representations made by management and accounting personnel. The following table provides examples of other individuals within the entity who might be able to help the auditor identify and assess the risk of material misstatement.

Examples of Inquiries of Others Within the Entity

.08

Inquiries of these individuals (outside of management or the financial reporting process, or both)	*May help the auditor understand*
Those charged with governance	• the environment in which the financial statements are prepared. • whether they have knowledge of any fraud or suspected fraud. • how they exercise oversight of the entity's programs and controls that address fraud. • their views on where the company is most vulnerable to fraud. • how financial statements are used.
Internal audit personnel	• the design and operating effectiveness of internal control. • internal audit activities related to internal control over financial reporting. • whether management has responded satisfactorily to internal audit findings. • their views on where the company is most vulnerable to fraud.

Employees involved in the initiation, processing, or recording of complex or unusual transactions	• the controls over the selection and application of accounting policies related to those transactions. • the business rationale for those transactions.
IT systems users	• how IT users identify changes to IT systems and how frequently those changes occur. • how users "work around" IT systems for those circumstances where the IT system does not support them. • how logical access to data and applications is controlled. • how remote access to the system is controlled. • excessive system down time and other indicators that the system is not functioning properly.
In-house legal counsel	• litigation. • compliance with laws and regulations. • fraud or suspected fraud. • warranties. • post sales obligations. • arrangements such as joint ventures. • the meaning of certain contract terms.
Marketing, sales, or production personnel	• marketing strategies. • sales trends. • production strategies. • contractual arrangements with customers. • any pressures to meet budgets or change reported performance measures.

Analytical Procedures

.09 AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), specifies that the auditor should apply analytical procedures in planning the audit. The objective of these procedures is to help the auditor understand the client and its environment and, ultimately, to assess the risk of material misstatement. As such, the auditor may consider the analytical procedures performed during audit planning to be a risk assessment procedure that provides some broad audit evidence to support the opinion on the financial statements.

.10 Please refer to paragraphs .06–.08 of AU section 329 for additional guidance on the performance of analytical procedures in planning the audit.

.11 The results of analytical procedures may help the auditor obtain an understanding of the entity. For example, analytical procedures may be helpful in identifying

- the existence of unusual transactions or events, which may indicate the presence of significant risks, and
- amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. For example, an unexpected amount, ratio, or trend may be the result of a misstatement that was not prevented or detected and corrected by the client's system of internal control.

Observations and Inspection of Documents

.12 The auditor may use observation and the inspection of documents to support the responses received to the inquiries of management and others. Additionally, the observations and inspections will provide the auditor with further information about the entity and its environment that might not otherwise be obtained.

.13 The procedures performed to observe activities and inspect documents typically include the following:

- Observation of client activities and operations
- Visits to the client's premises and plant facilities
- Inspection of documents, records, and internal control manuals
- Reading reports prepared by management (such as quarterly management reports and interim financial statements)
- Reading minutes of board of directors' meetings and other documents prepared by those charged with governance
- Tracing transactions through the financial reporting information system (walkthroughs)

A Mix of Procedures

.14 The auditor is not required to perform all the risk assessment procedures described previously for each aspect of the understanding described in the following section. However, all the risk assessment procedures should be performed by the auditor in the course of obtaining the required understanding.

Discussion Among the Audit Team

.15 The members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity's financial statements to material misstatements. The objectives of this discussion are for team members to

- gain a better understanding of the potential for misstatements in the specific areas assigned to them, and
- understand how the results of the audit procedures they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures.

.16 This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 to discuss the susceptibility of the entity's financial statements to fraud.

.17 Topics for audit team discussion include the following:

- Areas of significant risk of material misstatement
- Unusual accounting procedures used by the client
- Important control systems
- Significant IT applications and how the client's use of IT may affect the audit
- Areas susceptible to management override of controls
- Materiality at the financial level and tolerable misstatement
- How materiality will be used to determine the extent of testing
- The application of generally accepted accounting principles to the client's facts and circumstances and in light of the entity's accounting policies

- The need to
  - — exercise professional skepticism throughout the engagement.
  - — remain alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred.
  - — follow up rigorously on any indications of a material misstatement.

.18 The auditor should exercise professional judgment to determine logistical matters relating to the audit discussion, such as who should participate, how and when the discussion should occur, and its extent. Key members of the audit team, including the auditor with final responsibility, should be involved in the discussion.

.19 When considering who should participate in the discussion, the auditor also may determine that an IT specialist or other individual possessing specialized skills is needed on the audit team and, therefore, include that individual in the discussion.

Understanding Specified Aspects of the Entity and Its Environment

.20 The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

a. Industry, regulatory, and other external factors

b. Nature of the entity

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements

d. Measurement and review of the entity's financial performance

e. Internal control, which includes the selection and application of accounting policies

.21 The nature, timing, and extent of the risk assessment procedures performed depend on the circumstances of the engagement, such as the size and complexity of the entity and the auditor's experience with it. In addition, identifying significant changes in any of the previously mentioned aspects of the entity from prior periods is particularly important in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

Industry, Regulatory, and Other External Factors

.22 The auditor should obtain an understanding of relevant industry, regulatory, and other external factors. These factors include industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments; the regulatory environment encompassing, among other matters, relevant accounting pronouncements, the legal and political environment, and environmental requirements affecting the industry and the entity; and other external factors, such as general economic conditions.

.23 The industry in which the entity operates may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (such as political, economic, social, technical, and competitive). For example, long term contracts may involve significant estimates of revenues and costs that give rise to risks of material misstatement of the financial statements. Similarly, regulations may specify certain financial reporting requirements for the industry in which the entity operates. In such cases, the auditor should consider whether the audit team includes members with sufficient relevant knowledge and experience. If management fails to comply with such regulations, its financial statements may be materially misstated.

Nature of the Entity

.24 The auditor should obtain an understanding of the nature of the entity. The nature of an entity refers to the entity's operations, its ownership, governance, the types of investments that it is making and plans to make, the way that the entity is structured, and how it is financed. An understanding of the nature of an entity enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

Objectives and Strategies and Related Business Risks

.25 The auditor should obtain an understanding of the entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements. The entity conducts its business in the context of industry, regulatory, and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the operational approaches by which management intends to achieve its objectives. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic and the entity's strategies and objectives change over time.

.26 Business risk is broader than the risk of material misstatement of the financial statements, although it includes the latter. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Usually management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraphs .76–.80 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1).

Measurement and Review of the Entity's Financial Performance

.27 The auditor should obtain an understanding of the measurement and review of the entity's financial performance. Performance measures and their review indicate to the auditor aspects of the entity's performance that management and others consider to be important. Performance measures, whether external or internal, create pressures on the entity that, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Obtaining an understanding of the entity's performance measures assists the auditor in considering whether such pressures result in management actions that may have increased the risks of material misstatement.

.28 Internally generated information used by management for this purpose may include key performance indicators (financial and nonfinancial); budgets; variance analysis; subsidiary information and divisional, departmental, or other level performance reports; and comparisons of an entity's performance with that of competitors. External parties may also measure and review the entity's financial performance. For example, external information, such as analysts' reports and credit rating agency reports, may provide information useful to the auditor's understanding of the entity and its environment. Such reports may be obtained from the entity being audited or from Web sites.

Internal Control

.29 Refer to AAM section 3125 for the discussion of internal control.

Documentation

.30 The auditor should document the key elements of the understanding obtained regarding each of the aspects of the entity and its environment, including each of the components of internal control (discussed in AAM section 3125) to assess the risks of material misstatement of the financial statements; the sources of information from which the understanding was obtained; and the risk assessment procedures.

[*The next page is 3201.*]

AAM Section 3125

Understanding of Internal Control

Introduction

.01 Internal control is broadly defined as a process designed to provide reasonable assurance regarding the achievement of the entity's 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 effected by those charged with governance, management, and other personnel.

.02 The previous definition reflects certain fundamental concepts that follow:

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 need to 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 should obtain an understanding of their client's internal control during the planning phase of every audit. Paragraph .40 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), states the following:

> The auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures.

.04 As a practical matter, the previous 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?

.05 This section provides answers to each of the previous questions.

What Auditors Should Understand About Internal Control

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

- The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented.

- This understanding is ordinarily 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 Obtaining an understanding of controls is different from testing the operating effectiveness of controls. Obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. Implementation of a control means that the control exists and that the entity is using it. The auditor should consider the design of a control in determining whether to consider its implementation. In contrast, the objective of testing the operating effectiveness of controls is to determine whether the controls, as designed, prevent or detect a material misstatement. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

.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 should determine whether this control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements and determine whether the controller actually performs the reconciliations. Not testing, but identifying controls are a key part of audit planning.*

.09 AU section 314 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 Ordinarily, 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. It is a matter of the auditor's professional judgment, as to the controls or combination of controls that may be assessed. However, as stated in paragraph .115 of AU section 314, for significant risks, to the extent the auditor has not already done so, the auditor should evaluate the design of the entity's related controls, including relevant control activities and determine whether they have been implemented.

.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 because 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 may 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 AU section 314 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 control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

Risk assessment. An entity's risk assessment process for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of financial statements that are presented fairly in conformity with generally accepted accounting principles. 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.

Control activities. Control activities are the policies and procedures that help ensure that management directives are carried out; for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives.

Information and communication systems. 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, authorize, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. The quality of system generated information affects management's ability to make appropriate decisions in controlling the entity's activities and to prepare reliable financial reports. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

Monitoring. Monitoring is a process that assesses the quality of internal control performance over time.

.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 paragraph .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 effect 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, and how, a specific control prevents or detects and corrects material misstatements in relevant assertions related to classes of transactions, account balances, or disclosures, rather than its classification into any particular component. 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 should obtain an understanding of internal control sufficient to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures. 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 activity*? 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 The auditor should obtain a sufficient understanding of internal control by performing risk assessment procedures (inquiries of management and others within the entity, analytical procedures, and observation and inspection) to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Procedures to obtain audit evidence about the design and implementation of relevant controls may include inquiring of entity personnel, observing the application of specific controls, inspecting documents and reports, and tracing transactions through the information system relevant to financial reporting. Inquiry alone is not sufficient to evaluate the design of a control relevant to an audit and to determine whether it has been implemented.

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

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

.28 *Jones Grocery purchased a commercially available software package for independent grocers. During 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 assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures.

.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.

Documenting the Understanding

.32 The auditor should document the key elements of the understanding obtained regarding each of the components of internal control, to assess the risks of material misstatement of the financial statements; the sources of information from which the understanding was obtained; and the risk assessment procedures. 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, authorized, 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 should document his or her work.

[*The next page is 3221.*]

AAM Section 3130

Assessing the Risks of Material Misstatement

General

.01 Knowledge an auditor acquires about a client encompasses a broad range of information, including the following:

- Industry, regulatory, and other external factors affecting the client
- The nature of the client, including its operations and organizational structure
- The client's objectives, strategies, and related business risks, some of which will give rise to risks affecting the financial statements
- How management measures and reviews the company's financial performance
- An understanding of the internal controls that are in use at the entity, including an understanding of the use of IT and the controls designed and used within the IT system

This knowledge of a client forms the basis for identifying risks and evaluating how these risks could result in financial statement misstatements.

.02 The auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should

- identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements.
- relate the identified risks to what can go wrong at the relevant assertion level.
- consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.
- consider the likelihood that the risks could result in a material misstatement of the financial statements.

.03 The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed. When the risk assessment is based on an expectation that controls are operating effectively to prevent or detect material misstatement, individually or when aggregated, at the relevant assertion level, the auditor should perform tests of the controls that the auditor has determined to be suitably designed to prevent or detect a material misstatement in the relevant assertion to obtain audit evidence that the controls are operating effectively, as described in AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1).

.04 The auditor should determine whether the identified risks of material misstatement relate to specific relevant assertions related to classes of transactions, account balances, and disclosures, or whether they relate more pervasively to the financial statements taken as a whole and potentially affect many relevant assertions.

Financial Statement Assertions

.05 Paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with generally accepted accounting procedures, management implicitly or explicitly makes assertions regarding the recognition, measurement, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories:

Categories of Assertions

	Description of Assertions		
	Classes of transactions and events during the period	*Account balances at the end of the period*	*Presentation and disclosure*
Occurrence/Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/valuation and allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described, and information in disclosures is expressed clearly.

.06 The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

Assessing Risks at the Financial Statement Level

.07 Risks of material misstatement at the financial statement level are those risks that relate pervasively to the financial statements and potentially affect many individual assertions. Risks at the financial statement level may derive in particular from a weak control environment. The nature of the risks arising from a weak control environment is such that they are not likely to be confined to specific individual risks of material misstatement in particular classes of transactions, account balances, and disclosures. Rather, weaknesses such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

.08 Characteristics of financial statement level risks that are relevant for audit purposes include the following:

- **Financial statement level risks can affect many assertions.** By definition, financial statement level risks may result in material misstatements of several accounts or assertions. For example, a lack of controls over journal entries increases the risk that an inappropriate journal entry could be posted to the general ledger as part of the period-end financial reporting process. The posting of an inappropriate journal entry may not be isolated to one general ledger account but potentially could affect any account. In general, overall audit risk increases when the magnitude or scope of an identified risk of misstatement is not known.
- **Assessing financial statement level risks requires significant judgment.** Ultimately, the auditor should relate identified risks of misstatement to what can go wrong. For example, suppose that while performing risk assessment procedures to gather information about the control environment, the auditor discovered weaknesses relating to the hiring, training, and supervision of entity personnel. These weaknesses result in an increased risk of a misstatement of the financial statements, but it will be a matter of the auditor's professional judgment to determine the following:
  - The accounts and relevant assertions that could be affected
  - The likelihood that a financial statement misstatement will result from the increased risk
  - The significance of any misstatement
- **Risks at the financial statement level may not be identifiable with specific assertions.** Control weaknesses at the financial statement level can render well designed activity level controls ineffective. For example, a significant risk of management override can potentially negate existing controls and procedures at the activity level in many accounts and for many assertions. Linking such a risk to specific accounts and assertions may be very difficult, and may not even be possible. As another example, a client may have excellent data input controls at the application level. But if poorly designed, IT general controls may allow many unauthorized personnel the opportunity to access and inappropriately change the data and the well designed input controls will be rendered ineffective. Also, strengths in financial statement level controls such as an overall culture of ethical behavior may increase the reliability of controls that operate at the activity level. Determining the extent to which financial statement level controls affect the reliability of specific activity level controls (and therefore the assessment of the risks of material misstatement) is subjective and may vary from client to client.

Assessing Risks at the Assertion Level

.09 In making risk assessments, the auditor should identify the controls that are likely to prevent or detect and correct material misstatements in specific relevant assertions. Generally, the auditor gains an understanding of controls and relates them to relevant assertions in the context of processes and systems in which they exist. Doing so is useful because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other elements of internal control, will be sufficient to address a risk.

.10 Conversely, some control activities may have a specific effect on an individual relevant assertion embodied in a particular class of transaction or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

.11 Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing or detecting and correcting misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Significant Risks That Require Special Audit Consideration

.12 As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), provides guidance to the auditor in determining whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. The auditor should evaluate the design of the entity's controls, including relevant control activities, over such risks and determine whether they are adequate and have been implemented. Paragraphs .45 and .53 of AU section 318 describe the consequences for further audit procedures of identifying risks as significant.

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

.13 As part of the risk assessment described in paragraph .12, the auditor should evaluate the design and determine the implementation of the entity's controls, including relevant control activities, over those risks for which, in the auditor's judgment, it is not possible or practicable to reduce detection risk at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures. The consequences for further audit procedures of identifying such risks are described in paragraph .24 of AU section 318.

Revision of Risk Assessment

.14 The auditor's assessment of the risks of material misstatement at the relevant assertion level is based on available audit evidence and may change during the course of the audit as additional audit evidence is obtained. In particular, the risk assessment may be based on an expectation that controls are operating effectively to prevent or detect and correct a material misstatement at the relevant assertion level. In performing tests of controls to obtain audit evidence about their operating effectiveness, the auditor may obtain audit evidence that controls are not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures, the auditor may detect misstatements in amounts or frequency that is greater than is consistent with the auditor's risk assessment. When the auditor obtains audit evidence from performing further audit procedures that tends to contradict the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and should further modify planned audit procedures accordingly. See paragraphs .70 and .74 of AU section 318 for further guidance.

Documentation

.15 The auditor should document (*a*) the assessment of the risks of material misstatement both at the financial statement level and at the relevant assertion level and the basis for the assessment and (*b*) the risks identified and related controls evaluated as a result of the requirements for significant risks.

[*The next page is 3271.*]

AAM Section 3140

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 (GAAP). 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 users of the financial statements. The perceived needs of users are recognized in the discussion of materiality in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, which defines materiality as

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

Nature and Causes of Misstatements

.03 The representation in the auditor's standard report regarding fair presentation, in all material respects, in conformity with generally accepted accounting principles indicates the auditor's belief that the financial statements, taken as a whole, are not materially misstated. Misstatements can result from errors or fraud.[1] and may consist of any of the following:

a. An inaccuracy in gathering or processing data from which financial statements are prepared

b. A 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

c. The omission of a financial statement element, account, or item

d. A financial statement disclosure that is not presented in conformity with GAAP

e. The omission of information required to be disclosed in conformity with GAAP

f. An incorrect accounting estimate arising, for example, from an oversight or misinterpretation of facts

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[1] The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1). See AAM section 3150, *Illegal Acts*. For those illegal acts that are defined in that statement as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts if the same as that for errors or fraud.

g. Management's judgments concerning an accounting estimate or the selection or application of accounting policies that the auditor may consider unreasonable or inappropriate

.04 Misstatements may be of two types: known and likely, defined as follows:

Known misstatements. These are specific misstatements identified during the audit arising from the incorrect selection or misapplication of accounting principles or misstatements of facts identified, including, for example, those arising from mistakes in gathering or processing data and the overlooking or misinterpretation of facts.

Likely misstatements. These are misstatements that:

a. arise from differences between management's and the auditor's judgments concerning accounting estimates that the auditor considers unreasonable or inappropriate (for example, because an estimate included in the financial statements by management is outside of the range of reasonable outcomes the auditor has determined).

b. the auditor considers likely to exist based on an extrapolation from audit evidence obtained (for example, the amount obtained by projecting known misstatements identified in an audit sample to the entire population from which the sample was drawn).

.05 The term *errors* refers to unintentional misstatements of amounts or disclosures in financial statements. The term *fraud* refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Two types of misstatements resulting from fraud are relevant to the auditor's consideration in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. These two types of misstatements are further described in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1).

.06 See AAM section 3145 for a further discussion on fraud.

.07 Although the auditor has no responsibility to plan and perform the audit to detect immaterial misstatements, there is a distinction in the auditor's response to detected misstatements depending on whether those misstatements are caused by error or fraud. When the auditor encounters evidence of potential fraud, regardless of its materiality, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

Considerations at the Financial Statements Level

.08 The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of:

a. determining the extent and nature of risk assessment procedures.

b. identifying and assessing the risks of material misstatement.

c. determining the nature, timing, and extent of further audit procedures.

d. evaluating whether the financial statements taken as a whole are presented fairly, in all material respects, in conformity with GAAP.

.09 Audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions, and disclosures and at the overall financial statement level. The auditor should perform risk assessment procedures to assess the risks of material misstatement both at the financial statement and the relevant assertion levels. The auditor may reduce audit risk by determining overall responses and designing the nature, timing, and extent of further audit procedures based on those assessments.

.10 The auditor should perform the audit to reduce audit risk to a low level that is, in the auditor's professional judgment, appropriate for expressing an opinion on the financial statements. Audit risk may be assessed in quantitative or nonquantitative terms.

.11 The considerations of audit risk and materiality are affected by the size and complexity of the entity and the auditor's experience with and knowledge of the entity and its environment, including its internal control. As discussed in the following section, "Considerations at the Individual Account Balance, Class of Transactions, or Disclosure Level," certain entity related factors also affect the nature, timing, and extent of further audit procedures with respect to relevant assertions related to specific account balances, classes of transactions, and disclosures.

.12 In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control. In developing responses to the risks of material misstatement at the overall financial statement level, the auditor should consider such matters as the knowledge, skill, and ability of personnel assigned significant engagement responsibilities; whether certain aspects of the engagement need the involvement of a specialist; and the appropriate level of supervision of assistants.

Considerations at the Individual Account Balance, Class of Transactions, or Disclosure Level

.13 In determining the nature, timing, and extent of audit procedures to be applied to a specific account balance, class of transactions, or disclosure, the auditor should design audit procedures to obtain reasonable assurance of detecting misstatements that the auditor believes, based on the judgment about materiality, could be material, when aggregated with misstatements in other balances, classes, or disclosures, to the financial statements taken as a whole.

.14 The auditor should consider audit risk at the individual account balance, class of transactions, or disclosure level because such consideration directly assists in determining the nature, timing, and extent of further audit procedures for the relevant assertions related to balances, classes, or disclosures. The auditor should seek to reduce audit risk at the individual balance, class, or disclosure level in such a way that will enable the auditor, 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.

.15 At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risk (consisting of inherent risk and control risk) that the relevant assertions related to balances, classes, or disclosures contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other relevant assertions related to balances, classes, or disclosures and (*b*) the risk (detection risk) that the auditor will not detect such misstatements. These components of audit risk may be assessed in quantitative terms, such as percentage-s,or in nonquantitative terms such as *high*, *medium*, or *low* risk. The way the auditor should consider these component risks and combines them involves professional judgment and depends on the auditor's approach or methodology.

.16 *Inherent risk* is the susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related account balances, classes of transactions, and disclosures 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 that are subject to significant measurement uncertainty pose greater risks than do accounts consisting of relatively routine, factual data. External circumstances giving rise to business risks 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 circumstances that are peculiar to a specific relevant assertion, factors in the entity and its environment that relate to several or all of the classes of transaction, account balances, or disclosures may influence the inherent risk related to a specific relevant assertion. These latter 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.

.17 *Control risk* is the risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, 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.

.18 Inherent risk and control risk are the entity's risks, that is, they exist independently of the audit of financial statements. AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), and other AU sections describe the risk of material misstatement as the auditor's combined assessment of inherent risk and control risk; however, the auditor may make separate assessments of inherent risk and control risk. Furthermore, auditors may implement the concepts surrounding the assessment of inherent and control risks and responding to the risk of material misstatement in different ways as long as they achieve the same result.

.19 The auditor should assess the risk of material misstatement at the relevant assertion level as a basis for further audit procedures. Although that assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. This basis may be obtained through the risk assessment procedures performed to obtain an understanding of the entity and its environment, including its internal control, and through the performance of suitable tests of controls to obtain audit evidence about the operating effectiveness of controls, where appropriate.

.20 *Detection risk* is the risk that the auditor will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor does not examine 100 percent of an account balance or a class of transactions and because of other factors. Such other factors include the possibility that an auditor might select an inappropriate audit procedure; misapply an appropriate audit procedure; or misinterpret the audit results. These other factors might be addressed through adequate planning; proper assignment of personnel to the engagement team; the application of professional skepticism, supervision, and review of the audit work performed; and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards. Detection risk can be disaggregated into additional components of tests of details risk and substantive analytical procedures risk.

.21 Detection risk relates to the substantive audit procedures and is managed by the auditor's response to risk of material misstatement. For a given level of audit risk, detection risk should bear an inverse relationship to the risk of material misstatement at the relevant assertion level. The greater the risk of material misstatement, the less the detection risk that can be accepted by the auditor. Conversely, the lower the risk of material misstatement, the greater the detection risk that can be accepted by the auditor. However, the auditor should perform substantive procedures for all relevant assertions related to material classes of transactions, account balances, and disclosures.

Materiality

.22 The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

Determining Materiality for the Financial Statements Taken as a Whole When Planning the Audit

.23 The auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. Determining a materiality level for the financial statements taken as a whole helps guide the auditor's judgments in identifying and assessing the risks of material misstatements and in planning the nature, timing, and extent of further audit procedures. This materiality level does not, however, establish a threshold below which identified misstatements are always considered to be immaterial when evaluating those misstatements and their effect on the financial statements and the auditor's report thereon.

.24 The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements taken as a whole. When identifying an appropriate benchmark, the auditor may consider factors such as the following:

- The elements of the financial statements (for example, assets, liabilities, equity, income, and expenses) and the financial statement measures defined in GAAP (for example, financial position, financial performance, and cash flows), or other specific requirements
- Whether there are financial statement items on which, for the particular entity, users' attention tends to be focused (for example, for the purpose of evaluating financial performance)
- The nature of the entity and the industry in which it operates
- The size of the entity, nature of its ownership, and the way it is financed

Examples of benchmarks that might be appropriate, depending on the nature and circumstances of the entity, include total revenues, gross profit, and other categories of reported income, such as profit before tax from continuing operations. Profit before tax from continuing operations may be a suitable benchmark for profit oriented entities but may not be an appropriate benchmark for the determination of materiality when, for example, the entity's earnings are volatile, when the entity is a not-for-profit entity, or when it is an owner managed business where the owner takes much of the pretax income out of the business in the form of remuneration. For asset based entities (for example, an investment fund) an appropriate benchmark might be net assets. Other entities (for example, banks and insurance companies) might use other benchmarks.

.25 When determining materiality, the auditor should consider prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, taking account of significant changes in the entity's circumstances (for example, a significant business acquisition) and relevant changes of conditions in the economy as a whole or the industry in which the entity operates.

.26 Once materiality is established, the auditor should consider materiality when planning and evaluating the same way regardless of the inherent business characteristics of the entity being audited.

Tolerable Misstatement

.27 The initial determination of materiality is made for the financial statement taken as a whole. However, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. *Tolerable misstatement* (or *tolerable error*) is the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Such levels of tolerable misstatement are normally lower than the materiality levels.

Qualitative Aspects of Materiality

.28 As indicated previously, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

.29 Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

Considerations as the Audit Progresses

.30 Because it is not feasible for the auditor to anticipate all the circumstances that may ultimately influence judgments about materiality in evaluating the audit findings at the completion of the audit, the auditor's judgment about materiality for planning purposes may differ from the judgment about materiality used in evaluating the audit findings.

.31 If the auditor concludes that a lower materiality level than that initially determined is appropriate, the auditor should reconsider the related levels of tolerable misstatement and appropriateness of the nature, timing, and extent of further audit procedures. The auditor should consider whether the overall audit strategy and audit plan need to be revised if the nature of identified misstatements and the circumstances of their occurrence are indicative that other misstatements may exist that, when aggregated with identified misstatements, could be material. The auditor should not assume that a misstatement is an isolated occurrence.

.32 If the aggregate of the misstatements (known and likely) that the auditor has identified approaches the materiality level, the auditor should consider whether there is a greater than acceptably low level of risk that undetected misstatements, when taken with the aggregate identified misstatements, could exceed the materiality level and, if so, the auditor should reconsider the nature and extent of further audit procedures.

Quantifying Materiality

.33 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.

.34 Generally, materiality guidelines are 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 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.

.35 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

.36 A common rule of thumb for materiality is 5 percent to 10 percent of pretax income (for profit-orientated entities). 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 percent to 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 percent and 10 percent as material. Others use 1 percent or 1.5 percent of the larger of total assets or revenues. (See exhibit 1 for a sample planning materiality worksheet.) Note that a percentage of pretax income may not be an appropriate benchmark for the determination of materiality when, for example, the entity's earnings are volatile, when the entity is a not-for-profit entity, or when the owner takes much of the pretax income out of the business in the form of remuneration.

Exhibit 1

	Initials	Date
Done	_______	_______
Reviewed	_______	_______

Client Name
Planning Materiality Worksheet
Balance Sheet Date

1.	Unaudited total assets at balance sheet date	_______
2.	Unaudited total revenues at balance sheet date	_______
3.	Select the larger of line *1* or line *2*	_______
4.	Select a multiplier if audit risk is normal, or, if better than normal, select .01	_______
5.	Multiply line *3* by line *4*	_______
6.	Unaudited pretax income (or equivalent if not a for-profit entity)	_______
7.	Select a multiplier if audit risk is normal, or, if better than normal, select .1	_______
8.	Multiply line *6* by line *7*	_______
9.	Evaluate line *5* and line *8* along with other relevant factors and determine materiality for audit planning purposes	_______

.37 Consideration of which base to use may 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 because pretax income is not meaningful.

SEC Staff Bulletin on Materiality for SEC Registrants

.38 Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 99, *Materiality*, 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.

.39 The SAB states that registrants and the auditors of their financial statements cannot 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/interps/account/sab99.htm.

Communication of Misstatements to Management

.40 The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial,[2] and communicate them to the appropriate level of management. This communication should occur on a timely basis.

.41 When communicating details of misstatements, the auditor should distinguish between known misstatements and likely misstatements. The auditor should request management to record the adjustment needed to correct all known misstatements, including the effect of prior period misstatement, other than those that the auditor believes are trivial.

.42 If management decides not to correct some or all of the known and likely misstatements communicated to it by the auditor or identified when management examined a class of transactions, account balance, or disclosure, the auditor should obtain an understanding of management's reasons for not making the corrections and should take that into account when considering the qualitative aspects of the entity's accounting practices and the implications for the auditor's report.

Evaluating Audit Findings

.43 In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with GAAP, the auditor must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. In making this evaluation, in relation to particular classes of transactions, account balances, and disclosures, the auditor should consider the size and nature of the misstatements and the particular circumstances of their occurrence and determine the effect of such misstatements on the financial statements taken as a whole.

.44 In aggregating misstatements, the auditor should include the effect on the current period's financial statements of those prior period misstatements. When evaluating the aggregate uncorrected misstatements, the auditor should consider the effects of these uncorrected misstatements in determining whether the financial statements are free of material misstatement.

.45 In evaluating the effects of misstatements, the auditor should include both qualitative and quantitative materiality considerations (see paragraphs .59–.60 of AU section 312). Qualitative considerations also influence the auditor in reaching a conclusion as to whether misstatements are material.

Likely Misstatements

.46 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*.

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[2] Matters that are "trivial" are amounts designated by the auditor below which misstatements need not be accumulated. This amount is 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.

.47 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.

.48 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.

.49 When auditing accounting estimates (for example, allowance for inventory obsolescence, allowance for doubtful accounts, or warranty obligations) 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

.50 *Known misstatements* are those for which the amount of the misstatements are specifically identified. Such misstatements are often supported by highly reliable evidence, such as third party documents. An example of a known misstatement would be a failure to record an invoice for repairs expense.

Misstatements From the Prior Year

.51 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

.52 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.

.53 Some firms establish a predetermined dollar threshold below which misstatements need not be accumulated. This amount may 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.

.54 When concluding as to whether the effect of misstatements, individually or in the aggregate, is material, an auditor should consider the nature and amount of the misstatements in relation to the nature and amount of items in the financial statements under audit.

.55 If the auditor believes that the financial statements taken as a whole are materially misstated, the auditor should request management to make the necessary corrections. If management refuses to make the corrections, the auditor must determine the implications for the auditor's report.

.56 If the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, they could still be materially misstated because of further misstatements remaining undetected. As the aggregate misstatements approach materiality, the risk that the financial statements may be materially misstated also increases; consequently, the auditor should also consider the effect of undetected misstatements in concluding whether the financial statements are fairly stated.

Documentation

.57 In addition to the documentation requirements in AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), AU section 312 states the auditor should document the following:

a. The levels of materiality, as discussed in paragraph .27 AU section 312, and tolerable misstatement, including any changes thereto, used in the audit and the basis on which those levels were determined

b. A summary of uncorrected misstatements, other than those that are trivial, related to known and likely misstatements

c. The auditor's conclusion as to whether uncorrected misstatements, individually or in aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion

d. All known and likely misstatements identified by the auditor during the audit, other than those that are trivial, that have been corrected by management

.58 Uncorrected misstatements should be documented in a manner that allows the auditor to

a. separately consider the effects of known and likely misstatements, including uncorrected misstatements identified in prior periods

b. consider the aggregate effect of misstatements on the financial statements

c. consider the qualitative factors that are relevant to the auditor's consideration whether misstatements are material (see paragraph .60 of AU section 312)

[*The next page is 3291.*]

AAM Section 3145

Fraud

General

.01 AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1), 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 .03 of AU section 110.

.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. Paragraph .03 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), states that the requirements and guidance set forth in AU section 316 are intended to be integrated into the overall audit process in a logical manner that is consistent with the requirements and guidance provided in other AU sections, including AU section 311, *Planning and Supervision*; AU section 312, *Audit Risk and Materiality in Conducting and Audit*; AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1). 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, and
- documents the auditor's consideration of fraud.

.03 Even though some requirements and guidance set forth in AU section 316 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 AU section 316 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. Paragraph .05 of AU section 316 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 Paragraph .14 of AU section 316 states that members of the audit team should 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 the following:

- 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–.18 of AU section 316 for further guidance.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

.11 In obtaining an understanding of the entity and its environment, including its internal control, 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 the following:

- 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–.34 of AU section 316 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 the following:

- 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[1]

.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 and pressures, opportunities, and attitudes and 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 following:

- 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

[1] Paragraph .102 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA *Professional Standards*, vol. 1), states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. This requirement provides a link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

- 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 Material misstatements due to fraudulent financial reporting often result from an overstatement or understatement of revenues. Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. In addition, 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 paragraph .57 of AU section 316) apart from any conclusions regarding the existence of more specifically identifiable risks.

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 AU section 314, 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[2]

.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 Judgments 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.

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[2] Paragraph .03 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), states that to reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. See paragraphs .04 and .07 of AU section 318. This requirement provides a link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

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 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–.56 of AU section 316 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–.67 of AU section 316.

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 When 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 audit evidence 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; and
- 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, Those Charged With Governance, and Others

.28 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. 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 those charged with governance. In addition, the auditor should reach an understanding with those charged with governance 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 significant deficiencies or material weaknesses in the entity's internal control that should be communicated to management and those charged with governance. 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 significant deficiencies or material weaknesses that should be communicated to management and those charged with governance.

.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 AU section 315, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1).
- 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

Practical Guidance

.32 The AICPA Practice Aid *Fraud Detection in a GAAS Audit—Revised Edition* provides a wealth of information and help on complying with the provisions of AU section 316. This practice aid is an other auditing publication as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

Fraud Risk Factor Memory Jogger

.33 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 following listing 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. An auditor should feel free to use this practice aid as he or she sees fit (for example, adding attachments, redesigning the form of the memory jogger). Finally, note that AU section 316 does not require an auditor to use a memory jogger or checklist of fraud risk factors.

Part 1—Fraudulent Financial Reporting

Fraud risk factors considered	*Present at client?*	*Audit response developed?*[3]	*Audit response documented? (W/P Ref.)*[4]	*Additional information*
A. Incentives and Pressures				
a. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by) the following:				
(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				
b. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:				
(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				
c. Management's personal net wealth is threatened by the entity's financial performance arising from the following:				
(1) Heavy concentrations of their personal net worth in the entity.				
(2) Personal guarantees of debt of the entity that are significant to their personal net worth.				

Fraud risk factors considered	Present at client?	Audit response developed?[3]	Audit response documented? (W/P Ref.)[4]	Additional information
(3) Adverse consequences on significant matters if *good* 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 (for example, marital status) of the owner-manager. However, if you become aware of such information, you may 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				

(continued)

Fraud risk factors considered	Present at client?	Audit response developed?[3]	Audit response documented? (W/P Ref.)[4]	Additional information
C. Attitudes and 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

Fraud risk factors considered	*Present at client?*	*Audit response developed?*[3]	*Audit response documented? (W/P Ref.)*[4]	*Additional information*
A. Incentives and 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 may consider it in conjunction with other risk factors and with mitigating controls.				
(2) Inadequate management oversight of employees responsible for assets.				
(3) Inadequate job applicant screening of employees with access to assets.				

(continued)

Fraud risk factors considered	Present at client?	Audit response developed?[3]	Audit response documented? (W/P Ref.)[4]	Additional information
(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 and 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				

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

[4] The auditor's response to identified risk factors should be documented. Documentation should be maintained at a place in the working papers 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 (for example, 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.

[*The next page is 3311.*]

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. 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 as described in AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1). 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. Normally, an audit conducted in accordance with generally accepted auditing standards 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 that 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 the following:

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 (see paragraphs .07–.11 of AU section 317, *Illegal Acts by Clients* [AICPA, *Professional Standards*, vol. 1]).

[*The next page is 3331.*]

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 audit evidence 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. The auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor's judgment about the expected effectiveness and efficiency of the available procedures. 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 in paragraph .02 of AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), 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] In accordance with paragraph .06 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), analytical procedures are also performed as risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control. Refer to AU section 314 for further guidance.

- "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 Also, in accordance with paragraph .09 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the auditor should apply analytical procedures in planning the audit to assist in understanding the entity and its environment and to identify areas that may represent specific risks relevant to the audit. For example, analytical procedures may be helpful in identifying the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. In performing analytical procedures as risk assessment procedures, the auditor should develop expectations about plausible relationships that are reasonably expected to exist. When comparison of those expectations with recorded amounts or ratios developed from recorded amounts yields unusual or unexpected relationships, the auditor should consider those results in identifying risks of material misstatement. However, when such analytical procedures use data aggregated at a high level (which is often the situation), the results of those analytical procedures provide only a broad initial indication about whether a material misstatement may exist. Accordingly, the auditor should consider the results of such analytical procedures along with other information gathered in identifying the risks of material misstatement.

.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 may be used to obtain assurance that material misstatements are not likely to exist in financial statement account balances. If analytical procedures are used for substantive testing, the auditor should focus his or her analytical procedures on particular assertions about account balances and should give 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.

.07 AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), provides requirements and guidance on the use of analytical procedures as substantive procedures. In designing substantive analytical procedures, the auditor should consider such matters as the following:

- The suitability of using substantive analytical procedures, given the assertions
- The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed
- Whether the expectation is sufficiently precise to identify the possibility of a material misstatement at the desired level of assurance
- The amount of any difference in recorded amounts from expected values that is acceptable

The auditor should consider testing the controls, if any, over the entity's preparation of information to be used by the auditor in applying analytical procedures. When such controls are effective, the auditor has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. When designing substantive analytical procedures, the auditor should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting some types of fraud. Alternatively, the auditor may consider whether the information was subjected to audit testing in the current or prior period. In determining the audit procedures to apply to the information upon which the expectation for substantive analytical procedures is based, the auditor should consider the guidance in paragraph .14 of AU section 318.

.08 In planning substantive analytical procedures, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced primarily by tolerable misstatement and should be consistent with the desired level of assurance. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balance, class of transactions, or disclosure could aggregate to an unacceptable amount. In designing substantive analytical procedures, the auditor should increase the desired level of assurance as the risk of material misstatement increases.

Analytical Procedure Process: Four Phases

.09 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.

.10 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)

.11 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, AU section 329 states that the expectation should be precise enough to provide the desired level of assurance that differences that may be potential misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate.

.12 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

.13 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)

.14 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 amount of difference that could be accepted without further explanation, 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 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.

.15 In investigation, the auditor should evaluate 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)

.16 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.

.17 If a reasonable explanation can not be obtained, in accordance with paragraph .50 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), the auditor must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. In making this evaluation, in relation to particular classes of transactions, account balances, and disclosures, the auditor should consider the size and nature of the misstatements and the particular circumstances of their occurrence and determine the effect of such misstatements on the financial statements taken as a whole. 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." In this case, the auditor should aggregate the misstatement, depending on materiality considerations, with other misstatements the entity has not corrected in the manner discussed in AU section 312.

Engagement Planning Procedures

.18 As stated previously, 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 audit evidence 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.

.19 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.

.20 Although analytical procedures used in planning the audit often use only financial data, sometimes relevant, nonfinancial 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.

Audit Documentation Requirements

.21 Paragraph .22 of AU section 329 states than 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

.22 For additional guidance, practitioners may 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 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.

.23 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 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 and ask for product no. 012558.

[*The next page is 3361.*]

AAM Section 3160

Audit Assignment Controls

.01

Audit Time Budget — Sample A

Client ______________________________ Audit date ______________________________

Prepared by ______________________________

Approved:

Supervisor ________________ Date __________ Partner ________________ Date __________

Preliminary work: Final work:

Start ____________ End ____________ Start ____________ End ____________

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

(Excludes tax and report departments' time)

.02

Audit Time Budget — Sample B

Date	Total hours — Accountant's initials color-coded				General														Cash			Inventories																			Other (describe)		
	Total	Supervisor or manager	Senior	Assistant	Audit program	Prior period reports Working papers, etc.	Trial balance and adjusting entries	Permanent file	Financial statement companion	Transactions since balance-sheet date	Preparation of reports	Internal control quest. and mgmt. letter	Time summary	Supervision	Correspondence and conferences	Review in-house computer programs	Audit of / with computer	General ledger and journal entries	In banks and on hand	Receipts and disbursements	Notes/accts. rec. and allowance for losses	Observation	Comparison of quantities	Valuation	Clerical accuracy and analytical review	Prepaid expenses	Other current assets	Fixed assets and depreciation	Investments	Other assets	Notes payable and long-term debt	Accounts payable	Other current liabilities	Other long-term liabilities and deferred income	Stockholders equity	Contingent liabilities	Sales and revenue	Payrolls	Other expense and income tests and analyses	Preparation of tax returns			
Budget																																											
Actual																																											

.03

Audit Time Analysis *(Short Form)*

Client Year Ended

	Prior Years		Budgeted Hours											Actual Daily Hours																						Next Year's Budget
			Total	Week Beginning																															Total	
Administration																																				
Accounting systems review																																				
Confirmations																																				
Permanent file																																				
Client advisory comments																																				
Report preparation																																				
Tax returns																																				
Initial review																																				
Overall review																																				
Detailed review																																				
Tax accrual review																																				
Trial balance																																				
Cash																																				
Receivables																																				
Inventories																																				
Other assets																																				
Liabilities																																				
Equity																																				
Operating accounts																																				
Totals																																				
Accountants																																				
In-charge																																				
Totals																																				

.04

Audit Time Analysis *(Long Form)*

Client Year Ended

	Prior Years		Budgeted Hours																																	
			Total	Week Beginning										Actual Daily Hours																					Total	Next Year's Budget
Administration																																				
Client conferences																																				
Planning and scheduling																																				
Staff supervision																																				
Accounting systems review																																				
Internal control																																				
EDP installation																																				
General ledger																																				
Cash																																				
Sales																																				
Voucher register																																				
Payroll																																				
Journal entries																																				
Confirmations																																				
Permanent file																																				
Client advisory comments																																				
Report preparation																																				
Financial statements																																				
Footnotes																																				
Tax return preparation																																				
Review																																				
Initial review																																				
Overall review																																				
Detailed review																																				
Tax accrual review																																				
Subtotal to next page																																				

Audit Time Analysis (*Long Form*)—continued

Client Year Ended

	Prior Years		Budgeted Hours Total	Week Beginning										Actual Daily Hours																					Total	Next Year's Budget
Year end verification																																				
Trial balance																																				
Cash																																				
Notes receivable																																				
Accounts receivable																																				
Inventories																																				
Prepaid expenses																																				
Intercompany accounts																																				
Securities and investments																																				
Fixed assets																																				
Other assets																																				
Notes payable																																				
Accounts payable																																				
Tax grouping and accrual																																				
Accrued liabilities																																				
Deferred credits																																				
Contingencies and commitments																																				
Equity																																				
Audit of/with computer																																				
Operating accounts																																				
Subtotal from previous page																																				
Totals																																				
Accountants																																				
Manager																																				
In-charge																																				
Totals																																				

.05

Weekly Progress Report

Date ____________________

Supervisor ____ In-charge accountant ________________________________

Client ____ Case ____

	Staff days—seven hours				
	Original Estimate	Used to date	Unused	Est. to complete	Variance
In-charge accountant					
Assistants *(list):*					
Total assistants					
Grand total					

[*The next page is 3401*.]

AAM Section 3165

Sample Engagement Letters

.01 Following are illustrative engagement letters. These illustrative letters are examples and may not include all representations necessary for a particular engagement. They may be used as a starting point in the design of specific letters and then tailored to satisfy the terms of a particular engagement. These illustrative engagement letters are intended to be used in connection with engagements of nonpublic entities and are not intended to be used in connection with audits of public entities that are required to be audited under standards set by the Public Company Accounting Oversight Board.

.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. (the Company) 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.

Audit Objective

The objective of our audit is the expression of an opinion as to whether your financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America and will include tests of accounting records and other procedures we consider necessary to enable us to express such an opinion. 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.

Audit Procedures

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Accordingly, the areas and number of transactions selected for testing will involve judgment. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by errors or fraud. 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]

Our procedures will include tests of 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 financial institutions. At the conclusion of our audit, we will request certain written representations (a "representation letter") from you about the financial statements and related matters.

Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements or noncompliance may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements, or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements. However, we will inform you and those charged with governance, defined as the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting process, of any material errors and any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform you and those charged with governance of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. Our responsibility as auditors is limited to the period covered by our audit and does not extend to matters that might arise during any later periods for which we are not engaged as auditors.

An audit includes obtaining an understanding of the entity and its environment, including its internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify deficiencies in internal control. However, we are responsible for communicating to you and those charged with governance internal control related matters that are required to be communicated under Statements on Auditing Standards.

Management Responsibilities

The Company's management is responsible for the basic financial statements and all accompanying information as well as all assertions contained therein. Encompassed in that responsibility are 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; fair presentation of the financial statements with generally accepted accounting principles; and compliance with relevant laws and regulations. Management is also responsible for making all financial records and related information available to us and for the accuracy and completeness of that information.

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.

The Company's management is responsible for the design and implementation of programs and controls to prevent and detect fraud and for informing us about all known or suspected fraud or illegal acts affecting the Company involving management, employees who have significant roles in internal control, and others where the fraud or illegal acts could have a material effect on the financial statements. Management's

[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, "Indemnification Clause in Engagement Letters," under AICPA Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 191 par. .188–.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. Note that the AICPA Professional Ethics Executive Committee is currently addressing the issue of indemnification clauses. Changes to independence rules regarding auditor indemnification and related issues are still pending. Practitioners should be alert to any final guidance.

responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud or illegal acts affecting the Company received in communications from employees, former employees, regulators, or others. In addition, the Company's management is responsible for identifying and ensuring that the Corporation complies with applicable laws and regulations and for taking timely and appropriate steps to remedy any fraud, illegal acts, or violations of contracts or grant agreements, or abuse that we may report.

Management is responsible for making all management decisions and performing all management functions, for designating an individual with suitable skill knowledge, or experience to oversee the tax services or any other nonattest services we provide, and for evaluating the adequacy and results of those services and accepting responsibility for them.

Other Engagement Matters and Limitations

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.

Professional standards require us to be independent with respect to the Company in the performance of our services. Any discussions that you have with personnel of our firm regarding employment could pose a threat to our independence. Therefore, we request that you inform us prior to any such discussions so that we can implement appropriate safeguards to maintain our independence. In addition, if you hire one of our personnel, you agree to pay us a fee of [XX] percent of that individual's base compensation at the Company, [xx] days from the first day of employment.

Audit Administration, Fees, and Other

We may from time to time, and depending on the circumstances, use third party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third party service provider. Furthermore, we will remain responsible for the work provided by any such third party service providers.[2]

Auditing standards generally accepted in the United States of America require that we communicate certain additional matters related to the conduct of our audit to those charged with governance. Such matters include (1) our responsibilities under auditing standards generally accepted in the United States of America; (2) an overview of the planned scope and timing of the audit; (3) significant findings from the audit, including, among others: (*a*) the initial selection of and changes in significant accounting policies and their application; (*b*) the process used by management in formulating particularly sensitive accounting estimates and the basis for our conclusions regarding the reasonableness of those estimates; (*c*) significant difficulties that we encountered in dealing with management related to the performance of the audit; (*d*) audit adjustments that could, in our judgment, either individually or in the aggregate, have a significant effect on your financial reporting process and uncorrected misstatements of the financial statements that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole; (*e*) any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the financial statements or our report; (*f*) management representations; (*g*) our views about matters that were the subject of management's consultation with other accountants about auditing and accounting matters; (*h*) major issues that were

[2] Ethics Ruling No. 112, "Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services," under Rule 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191 par. .224-.225) requires that clients be informed if the firm will outsource professional services to third party service providers. If an audit firm intends to use third party service providers (that is, entities not controlled by the audit firm or individuals not employed by the audit firm), to perform portions of the audit (for example, input tax return information, act as a specialist, or audit an element of the financial statements), the client must be informed before confidential client information is shared with the service provider. If a third party service provider is not used to perform professional services, this paragraph can be omitted.

discussed with management in connection with the retention of our services, including, among other matters, any discussions regarding the application of accounting principles and auditing standards, and if applicable, events or conditions indicating there could be a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time; and (4) other matters as considered necessary or required to be communicated under professional standards.

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 costs and administrative 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 we estimate to range from $XX,XXX to $XX,XXX. Additional expenses are expected to be $X,XXX.

The audit documentation for this engagement is the property of Lacko, Lynch, Brown & Company and constitutes confidential information. However, we may be requested to make certain audit documentation available to ______________________ [*name of regulator*] pursuant to authority given to it by law or regulation. If requested, access to such audit documentation will be provided under the supervision of Lacko, Lynch, Brown & Company personnel. Furthermore, upon request, we may provide photocopies of selected audit documentation 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.

We appreciate the opportunity to serve you and trust that our association will be a long and pleasant one. If you have any questions, please contact us. If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

____

[*Engagement Partner's Signature*]

Accepted and agreed to:

____

[*Client Representative's Signature*]

____

[*Title*]

____

[*Date*]

.03 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*]

.04 Conditions Encountered That 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 appropriate audit evidence 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.

.05 Audit of Not-for-Profit Financial Statements

LACKO, LYNCH, BROWN & COMPANY — Certified Public Accountants

[*Date*]
Mr. Matt Smith, President
Not-for-Profit Organization
222 Burnside Highway
Sharpsburg, Maryland 00000

Dear Mr. Smith:

This will confirm our understanding of the services we will provide to Not-for-Profit Organization (the Organization) for the year ending December 31, 20XX.

We will audit the balance sheet of Not-for-Profit Organization as of December 31, 20XX, and the related statements of activities and cash flows for the year then ended, for the purpose of expressing an opinion on them.

Audit Objective

The objective of our audit is the expression of an opinion as to whether your financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America and will include tests of accounting records and other procedures we consider necessary to enable us to express such an opinion. 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.

Audit Procedures

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Accordingly, the areas and number of transactions selected for testing will involve judgment. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether from errors or fraud. 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.[3]

Our procedures will include tests of 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 individuals, funding sources, creditors, legal counsel, and financial institutions. At the conclusion of our audit, we will request certain written representations (a "representation letter") from you about the financial statements and related matters.

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[3] 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 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 191 par. .188–.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. Note that the AICPA Professional Ethics Executive Committee is currently addressing the issue of indemnification clauses. Changes to independence rules regarding auditor indemnification and related issues are still pending. Practitioners should be alert to any final guidance.

Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements or noncompliance may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements, or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements. However, we will inform you and those charged with governance, defined as the person(s) with responsibility for overseeing the strategic direction of the organization and obligations related to the accountability of the organization, including oversight of the financial reporting process, of any material errors and any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform you and those charged with governance of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. Our responsibility as auditors is limited to the period covered by our audit and does not extend to matters that might arise during any later periods for which we are not engaged as auditors.

An audit includes obtaining an understanding of the Organization and its environment, including its internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify deficiencies in internal control. However, we are responsible for communicating to you and those charged with governance internal control related matters that are required to be communicated under Statements on Auditing Standards.

Management Responsibilities

The Organization's management is responsible for the basic financial statements and all accompanying information as well as all assertions contained therein. Encompassed in that responsibility are 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; fair presentation of the financial statements with generally accepted accounting principles; and compliance with relevant laws and regulations. Management is also responsible for making all financial records and related information available to us and for the accuracy and completeness of that information.

The Organization'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.

The Organization's management is responsible for the design and implementation of programs and controls to prevent and detect fraud and for informing us about all known or suspected fraud affecting the Organization involving management, employees who have significant roles in internal control, and others where the fraud could have a material effect on the financial statements. Management's responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud affecting the Organization received in communications from employees, former employees, regulators, or others. In addition, the Organization's management is responsible for identifying and ensuring that the Organization complies with applicable laws and regulations and for taking timely and appropriate steps to remedy any fraud, illegal acts, or violations of contracts or grant agreements, or abuse that we may report. Management is responsible for making all management decisions and performing all management functions, for designating an individual with suitable skill knowledge, or experience to oversee the tax services or any other nonattest services we provide, and for evaluating the adequacy and results of those services and accepting responsibility for them.

Other Engagement Matters and Limitations

As part of our engagement, we will prepare the Federal Form 990 and [*identify other returns*] for the year ended [*date*]. This return will be prepared in accordance with professional standards and may be processed by a contract computer service that has agreed to maintain the confidentiality of all information furnished.

Our work in connection with the preparation of the Form 990 does not include any procedures designed to discover defalcations or other fraud, should any exist.

You have the final responsibility for the Form 990. Therefore, you should review it carefully before you sign and file it.

Professional standards require us to be independent with respect to the Organization in the performance of our services. Any discussions that you have with personnel of our firm regarding employment could pose a threat to our independence. Therefore, we request that you inform us prior to any such discussions so that we can implement appropriate safeguards to maintain our independence. In addition, if you hire one of our personnel, you agree to pay us a fee of [XX] percent of that individual's base compensation at the Organization, [XX] days from the first day of employment.

Audit Administration, Fees, and Other

We may from time to time, and depending on the circumstances, use third party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third party service provider. Furthermore, we will remain responsible for the work provided by any such third party service providers.[4]

Auditing standards generally accepted in the United States of America require that we communicate certain additional matters related to the conduct of our audit to those charged with governance. Such matters include (1) our responsibilities under auditing standards generally accepted in the United States of America; (2) an overview of the planned scope and timing of the audit; (3) significant findings from the audit, including, among others: (*a*) the initial selection of and changes in significant accounting policies and their application; (*b*) the process used by management in formulating particularly sensitive accounting estimates and the basis for our conclusions regarding the reasonableness of those estimates; (*c*) significant difficulties that we encountered in dealing with management related to the performance of the audit; (*d*) audit adjustments that could, in our judgment, either individually or in the aggregate, have a significant effect on your financial reporting process and uncorrected misstatements of the financial statements that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole; (*e*) any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the financial statements or our report; (*f*) management representations; (*g*) our views about matters that were the subject of management's consultation with other accountants about auditing and accounting matters; (*h*) major issues that were discussed with management in connection with the retention of our services, including, among other matters, any discussions regarding the application of accounting principles and auditing standards, and if applicable, events or conditions indicating there could be a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time; and (4) other matters as considered necessary or required to be communicated under professional standards.

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.

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[4] Ethics Ruling No. 112 under Rule 102 (AICPA, *Professional Standards*, vol. 2, ET sec. 191 par. .224-.225) requires that clients be informed if the firm will outsource professional services to third party service providers. If the an audit firm intends to use third party service providers (that is, entities not controlled by the audit firm or individuals not employed by the audit firm), to perform portions of the audit (for example, input tax return information, act as a specialist, or audit an element of the financial statements), the client must be informed before confidential client information is shared with the service provider. If a third party service provider is not used to perform professional services, this paragraph can be omitted.

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 costs and administrative 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 we estimate to range from $XX,XXX to $XX,XXX. Additional expenses are expected to be $X,XXX.

The audit documentation for this engagement is the property of Lacko, Lynch, Brown & Company and constitutes confidential information. However, we may be requested to make certain audit documentation available to [*name of regulator*] pursuant to authority given to it by law or regulation. If requested, access to such audit documentation will be provided under the supervision of Lacko, Lynch, Brown & Company personnel. Furthermore, upon request, we may provide photocopies of selected audit documentation 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.

We appreciate the opportunity to serve you and trust that our association will be a long and pleasant one. If you have any questions, please contact us. If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

____

[*Engagement Partner's Signature*]

Accepted and agreed to:

____

[*Client Representative's Signature*]

____

[*Title*]

____

[*Date*]

.06 Audit of Not-for-Profit Financial Statements Subject to the Provisions of OMB Circular A-133

LACKO, LYNCH, BROWN & COMPANY — Certified Public Accountants

[*Date*]
Mr. Matt Cox, President
Not-for-Profit Organization
333 Burnside Highway
Sharpsburg, Maryland 00000

Dear Mr. Cox:

This will confirm our understanding of the services we will provide to Not-for-Profit Organization (the Organization) for the year ending December 31, 20XX.[5]

We will audit the balance sheet of Not-for-Profit Organization as of December 31, 20XX, and the related statements of activities, changes in partners' capital, and cash flows for the year then ended, for the purpose of expressing an opinion on them. We also will report on the following additional information accompanying the basic financial statements: (1) schedule of expenditures of federal awards and (2) [*insert additional information here*].

Audit Objectives

The objective of our audit is the expression of an opinion as to whether your financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America and to report on the additional information referenced in the second paragraph of this letter when considered in relation to the financial statements taken as a whole.

Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America; the standards for financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; the Single Audit Act Amendments of 1996; and the requirements of OMB Circular A-133, and will include tests of accounting records and other procedures we consider necessary to enable us to express such an opinion and to render the required reports. 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 will also provide a report (that does not include an opinion) on internal control related to the financial statements and compliance with the provisions of applicable laws, regulations, contracts, agreements, and grants, noncompliance with which could have a material effect on the financial statements as required by *Government Auditing Standards*. The report on internal control and compliance will include a statement that the report is intended solely for the information and use of management, [*insert audit committee, if applicable*], the board of directors, and specific legislative or regulatory bodies, federal awarding agencies, and if applicable, pass through entities and is not intended to be and should not be used by anyone other than these specified parties. If, during our audit, we become aware that the Company is subject to an audit requirement that is not encompassed in the terms of this engagement, we will communicate to management and those charged with governance that an audit is accordance with auditing standards generally accepted in the United States of America and the standards for financial audits contained in *Government Auditing Standards* may not satisfy the relevant legal, regulatory, or contractual requirements.

Audit Procedures

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[5] *Note to users of this sample engagement letter*: You may add to the engagement letter as appropriate, for additional considerations, such as performing procedures relating to a compliance audit of or limited scope audits of subrecipients, the involvement of other auditors (for example, a joint audit with a minority firm), or the auditee's responsibility for obtaining the cooperation of the predecessor auditor.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Accordingly, the areas and number of transactions selected for testing will involve judgment. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether from errors or fraud. 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.[6]

Our procedures will include tests of 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 individuals, funding sources, creditors, legal counsel, and financial institutions. At the conclusion of our audit, we will request certain written representations (a "representation letter") from you about the financial statements and related matters.

Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements or noncompliance may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements. However, we will inform you and those charged with governance, defined as the person(s) with responsibility for overseeing the strategic direction of the organization and obligations related to the accountability of the organization, including oversight of the financial reporting process, of any material errors and any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform you and those charged with governance of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. Our responsibility as auditors is limited to the period covered by our audit and does not extend to matters that might arise during any later periods for which we are not engaged as auditors.

As part of our audit of the basic financial statements, we will obtain an understanding of the Organization and its environment, including its internal control, sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of our auditing procedures for the purpose of expressing our opinion on the financial statements. Our audit is not designed to provide an opinion on the [*abbreviated name*]'s internal control over financial reporting or to identify deficiencies in the design or operation of internal control over financial reporting. However, we are responsible for communicating to you and those charged with governance internal control related matters that are required to be communicated under Statements on Auditing Standards, *Government Auditing Standards*, and the requirements of OMB Circular A-133.

We also will perform tests of the Organization's compliance with certain provisions of laws, regulations, and the provisions of contracts or grant agreements. However, it is not our objective to provide an opinion on overall compliance with those provisions and, accordingly, we will not express such an opinion.

In planning the audit, we will follow up on known significant findings and recommendations from previous financial audits, attestation engagements, performance audits, or other studies that directly relate to the objectives of the current audit to determine the effect on our risk assessment and audit procedures.

As part of our audit, we will be alert to situations or transactions that could be indicative of abuse, which involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. The determination

[6] 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 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 191 par. .188–.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. Note that the AICPA Professional Ethics Executive Committee is currently addressing the issue of indemnification clauses. Changes to independence rules regarding auditor indemnification and related issues are still pending. Practitioners should be alert to any final guidance.

of abuse is subjective; *Government Auditing Standards* does not expect us to provide reasonable assurance of detecting abuse, and we will not design the audit to detect abuse. However, if we become aware of indications of material abuse, we will apply procedures to ascertain whether abuse has occurred.

A schedule of expenditures of federal awards will accompany the Organization's basic financial statements. We will subject that schedule to the audit procedures applied in our audit of the basic financial statements and render our opinion on whether that schedule is fairly presented, in all material respects, in relation to the basic financial statements taken as a whole. We also will make specific inquiries of management about that schedule, which management will affirm to us in its representation letter.

Management Responsibilities

The Organization's management is responsible for the basic financial statements and the schedule of expenditures of federal awards as well as all assertions contained therein. Encompassed in that responsibility are 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 the identification of and compliance with laws, regulations, and the provisions of contracts or grant agreements. Management is responsible for making all financial records and related information available to us and for the accuracy and completeness of that information. Management also is responsible for adjusting the basic financial statements to correct material misstatements and for affirming to us in its representation letter that the effects of any uncorrected misstatements that we accumulate during the current audit and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the basic financial statements.

The Organization's management is responsible for the design and implementation of programs and controls to prevent and detect fraud and for informing us about all known or suspected fraud or illegal acts affecting the Organization involving management, employees who have significant roles in internal control, and others where the fraud or illegal acts could have a material effect on the financial statements. Management's responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud or illegal acts affecting the Organization received in communications from employees, former employees, regulators, or others.

You are responsible for making all management decisions and performing all management functions, for designating an individual with suitable skill knowledge, or experience to oversee the tax services or any other nonattest services we provide, and for evaluating the adequacy and results of those services and accepting responsibility for them.

Compliance Audit of Federal Programs

The Organization's management is responsible for compliance with laws, regulations, and the provisions of contracts or grant agreements related to federal programs. Encompassed in that responsibility is the establishment and maintenance of internal control over compliance that provides reasonable assurance that the Organization is managing federal awards in compliance with laws, regulations, and provisions of contracts or grant agreements.

Our responsibility is to express an opinion on whether the Organization complied with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the Organization's major federal programs. Following the criteria for federal program risk in OMB Circular A-133, we will determine which federal programs should be considered major programs and thus included within the scope of the compliance audit.[7]

We will plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements that are applicable to the Organization's major federal programs could have a direct and material effect on each of its major federal programs. An audit of compliance includes examining, on a test basis, evidence about the Organization's compliance with those requirements and

[7] *Note to users of this sample engagement letter:* This paragraph may be modified if the auditor elects to use a dollar threshold approach to selecting major programs, as allowed by A-133 for first-year single audits.

performing such other procedures we consider necessary in the circumstances. Our audit does not provide a legal determination on the Organization's compliance with those requirements.

As part of our audit of compliance applicable to the Organization's major federal programs, we will obtain an understanding of the Organization's internal control over compliance sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of our auditing procedures for the purpose of expressing our opinion on compliance and not to provide assurance on the internal control over compliance. We also will perform testing of internal control as required by OMB Circular A-133. We are responsible for communicating to you and those charged with governance internal control related matters that are required to be communicated under AICPA professional standards, *Government Auditing Standards*, and the requirements of OMB Circular A-133.

We also will follow up on prior audit findings by performing procedures to assess the reasonableness of the Organization's summary schedule of prior audit findings.

We will include in our reports information about the following, if any: material noncompliance with laws, regulations, and provisions of contracts or grant agreements related to major programs; certain known questioned costs; fraud affecting federal awards; abuse that is material to a federal program; and other federal award audit findings as required by *Government Auditing Standards* and OMB Circular A-133.

Other Communications Arising From the Audit

In connection with planning and performing our audit, we will communicate certain matters to appropriate Organization's personnel and to those charged with governance, including our responsibilities for testing and reporting on internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements, both for our financial statement audit and our compliance audit of major federal programs.[8] We also will communicate certain matters of interest, as applicable, to the audit committee, including changes in significant accounting policies or their application, adjustments arising from the audit that could either individually or in the aggregate have a significant effect on the Organization's financial reporting process, and fraud involving senior management that is not otherwise included in our reports.

Auditing standards generally accepted in the United States of America require that we communicate certain additional matters related to the conduct of our audit to those charged with governance. Such matters include (1) our responsibilities under auditing standards generally accepted in the United States of America; (2) an overview of the planned scope and timing of the audit; (3) significant audit findings, including, among others: (*a*) the initial selection of and changes in significant accounting policies and their application; (*b*) the process used by management in formulating particularly sensitive accounting estimates and the basis for our conclusions regarding the reasonableness of those estimates; (*c*) serious difficulties that we encountered in dealing with management related to the performance of the audit; (*d*) audit adjustments that could, in our judgment, either individually or in the aggregate, have a significant effect on your financial reporting process and uncorrected misstatements of the financial statements that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole; (*e*) any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the financial statements or our report; (*f*) management representations; (*g*) our views about matters that were the subject of management's consultation with other accountants about auditing and accounting matters; (*h*) major issues that were discussed with management in connection with the retention of our services, including, among other matters, any discussions regarding the application of accounting principles and auditing standards, and if applicable, events or conditions indicating there could be a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time; and (4) other matters as considered necessary or required to be communicated under professional standards.

In planning and performing our audit, we will ask management, those charged with governance, the internal auditor, and others within the entity about fraud or suspected fraud; allegations of fraud or

[8] *Note to users of this sample engagement letter: Government Auditing Standards*, paragraphs 4.08–.09, specifies the parties to whom this communication should be made.

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 those charged with governance; and how management communicates to employees its views on business practices and ethical behavior.

We also may communicate in a management letter certain matters identified during the audit or possible ways to improve the Organization's operational efficiency and effectiveness or otherwise improve its internal control or other policies or procedures. Under GAAS and *Government Auditing Standards*, we also may be required to directly report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse to outside parties.

Other Engagement Matters and Limitations

As part of our engagement, we will prepare the Federal Form 990 [*and identify other returns*] for the year ended [*date*]. This return will be prepared in accordance with professional standards and may be processed by a contract computer service that has agreed to maintain the confidentiality of all information furnished.

Our work in connection with the preparation of Form 990 does not include any procedures designed to discover defalcations or other fraud, should any exist.

You have the final responsibility for the Form 990. Therefore, you should review it carefully before you sign and file it.

Professional standards require us to be independent with respect to the [*abbreviated name*] in the performance of our services. Any discussion that you have with personnel of our firm regarding employment could pose a threat to our independence. Therefore, we request that you inform us prior to any such discussions so that we can implement appropriate safeguards to maintain our independence. In addition, if you hire one of our personnel, you agree to pay us a fee of [XX] percent of that individual's base compensation at the [*abbreviated name*], [XX] days from the first day of employment.

Audit Administration, Fees, and Other

We may from time to time, and depending on the circumstances, use third party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third party service provider. Furthermore, we will remain responsible for the work provided by any such third party service providers.[9]

The Organization agrees to make available to us all records, documentation, and information we request in connection with our audit, to disclose to us all material information, and to give to us the full cooperation of the Organization's personnel. An enclosure to this letter describes the assistance to be supplied by Organization personnel, including preparation of schedules and analyses of accounts, and the timing for that assistance. Timely completion of that work will facilitate the conclusion of our audit.

The Organization agrees to provide us printer's proofs of its basic financial statements, schedule of expenditures of federal awards, and other information for its Circular A-133 reporting package for our review and approval before printing. The [abbreviated name] also agrees to provide us with a copy of the final reproduced material for our approval before distributing it.

[9] Ethics Ruling No. 112 under Rule 102 (AICPA, *Professional Standards*, vol. 2, ET sec. 191 par. .224–.225) requires that clients be informed if the firm will outsource professional services to third party service providers. If the an audit firm intends to use third party service providers (that is, entities not controlled by the audit firm or individuals not employed by the audit firm), to perform portions of the audit (for example, input tax return information, act as a specialist, or audit an element of the financial statements), the client must be informed before confidential client information is shared with the service provider. If a third party service provider is not used to perform professional services, this paragraph can be omitted.

The Organization also is responsible for:

- Taking timely and appropriate steps to remedy fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that we report.
- Having a process to track the status of audit findings and recommendations.
- Identifying for us previous financial audits, attestation engagements, performance audits, or other studies related to the objectives of our audit and the corrective actions taken to address significant findings and recommendations.
- Providing its views on our current findings, conclusions, and recommendations, as well as management's planned corrective actions, for our reports. The corrective action plan that the Organization develops for its OMB Circular A-133 reporting package may fully or partially satisfy this responsibility.

Our reports on the Organization's internal control and compliance will state that they are intended solely for the information and use of those charged with governance, management, federal awarding agencies, and pass-through entities and are not intended to be and should not be used by anyone other than these specified parties. However, the Organization should make copies of our reports available for public inspection unless they are restricted by law or regulation, or contain privileged and confidential information.

The documentation for this audit is our firm's property and constitutes confidential information. We will maintain that documentation for the minimum period of time required by applicable auditing standards and requirements. In accordance with *Government Auditing Standards*, OMB Circular A-133, and federal law, we may be required, upon request, to make certain of that documentation (including photocopies) available to other auditors or reviewers, including the cognizant or oversight agency for audit or its designee, a federal agency providing direct or indirect funding, and the U.S. Government Accountability Office. Those parties may intend, or decide, to distribute the photocopies or information contained therein to others, including other governmental agencies and the public. We will notify you of any such requests.

Our firm undergoes a periodic external peer review that examines the quality of our auditing practice. We are enclosing with this letter a copy of the report and letter of comment from our firm's most recent external peer review.

We are always available to meet with you or other executives at various times throughout the year to discuss current business, operational, accounting, and auditing matters affecting the Organization. Whenever you feel such meetings are desirable, please let us know. We also are prepared to provide services to assist you in any of these areas. We also will be pleased, at your request, to attend your directors' meetings.

If the Organization wishes to assert that it complied, in all material respects, with specified laws and regulations, we could perform an engagement in accordance the American Institute of Certified Public Accountants' and *Government Auditing Standards'* attestation standards. The procedures we would perform would be more limited than if we were to express an opinion on management's assertions.

Our fee estimate, which is shown in a separate schedule, is based on a "core" amount for the financial statement audit and tax return preparation services plus an incremental amount for the compliance audit of federal programs, based on the Organization's actual number of major programs.[10] We also will charge the Organization for our out-of-pocket expenses. We will bill our fees as work progresses with payment to be made upon presentation. Our initial fee estimate and our target date for delivering our reports assume that we will receive the aforementioned assistance from Organization personnel and that we will not encounter unexpected circumstances. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of fees or our report delivery date, which is on or about [*date*]. Prior to the release of the audit reports, we will require payment of 100 percent of all fees billed.

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[10] *Note to users of this sample engagement letter:* Various factors may change the level of effort required for the compliance audit of federal programs from year-to-year. For example, the auditee may have more or fewer federal programs or major programs because of new or discontinued federal programs, increased or decreased federal funding for existing programs, and OMB changes in program clusters, or the auditee may achieve or lose low risk auditee status. As shown in this sample letter, auditors could consider pricing their services for the compliance audit based on the number of major programs to be audited.

Our charges for other services will be agreed to separately.

* * *

The arrangements described in this letter will be updated annually.

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

____

[*Engagement Partner's Signature*]

Accepted and agreed to:

____

[*Client Representative's Signature*]

____

[*Title*]

____

[*Date*]

Attachments: Required assistance from [*Name of Client*] personnel; peer review report and letter of comment for the CPA firm's most recent peer review; fee schedule

[*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 authorita tive pronouncements when appropriate.

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AAM Section 4100

Introduction

Overview

.01 As discussed in AAM section 3125, the auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. A *sufficient* understanding means the auditor should perform risk assessment procedures to evaluate the design of controls relevant to an audit and to determine whether they have been implemented. 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.

.02 AU section 314, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), provides a framework to help the auditor obtain an understanding of internal control. This framework breaks internal control into five components as identified in paragraph .03 of AAM section 4200, *Internal Control Framework*. The division of internal control into the five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit.

.03 The auditor's understanding of internal control is used to

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

.04 The auditor's understanding of a client's internal control should be based on previous experience with the client and the following:

- Inquiries of appropriate management, supervisory, and staff personnel
- Analytical procedures
- Inspection of documents and records
- Observation of the entity's activities and operations

.05 AAM section 4200 provides more detail on the internal control framework described in AU section 314. Refer to AAM section 5100, *Designing Further Audit Procedures*, for guidance pertaining to the design of further audit procedures (tests of controls or substantive procedures, or both) and AAM section 5200, *Performing Tests of Controls*, for specific guidance on the performance of tests of controls.

[*The next page is 4201.*]

AAM Section 4200

Internal Control Framework

Introduction

.01 As described in AAM section 3125, AU section 314, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), provides a framework to help the auditor 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*, which 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 paragraph .02, not all of these objectives and related controls are relevant to an effective audit of an entity's financial statements. Ordinarily, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements that are fairly presented in conformity with generally accepted accounting principles (GAAP), including the management of risk that may give rise to a risk of material misstatement in those financial statements. 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 run out of stock. 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 the auditor evaluates or uses 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 might 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
- What files are processed
- What nature of processing is involved in producing the report

.09 Controls relating to operations and compliance objectives may, however, be relevant to an audit if they pertain to information or data the auditor may evaluate or use in applying audit procedures. For example, controls pertaining to nonfinancial data that the auditor may use in analytical procedures, such as production statistics, or 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 the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. In obtaining an understanding of each of the components of internal control, the auditor's consideration of safeguarding controls is generally limited to those relevant to the reliability of financial reporting. For example, use of 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, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

.11 The internal control framework described in AU section 314 is only a means to help the auditor consider the impact of an entity's internal control in an audit. The auditor's primary consideration is whether, and how, a specific control prevents or detects and corrects material misstatements in relevant assertions related to classes of transactions, account balances, or disclosures, rather than its classification into any particular component. 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 should obtain an understanding of internal control sufficient to assess the risks of material misstatement and to design the nature, timing, and extent of further audit procedures. 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 because 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, authorized, 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, reconciliations, and follow-ups of reconciling items. Alternatively, an entity may have information systems that use automated procedures to initiate, authorize, 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. When IT is used to initiate, authorize, 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 material accounts or may be critical to the effective functioning of manual controls that depend on IT. 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; and
- 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; and
- potential loss of data or inability to access data as required.

.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 Manual controls of systems may be more suitable where judgment and discretion are required, such as for the following circumstances:

- Large, unusual, or nonrecurring transactions
- Circumstances where misstatements are difficult to define, anticipate, or predict
- In changing circumstances that require a control response outside the scope of an existing automated control
- In monitoring the effectiveness of automated controls

.20 Manual controls are performed by people and, therefore, pose specific risks to the entity's internal control. Manual controls may be less reliable than automated controls because they can be more easily bypassed, ignored, or overridden and they are also more prone to errors and mistakes. Consistency of application of a manual control element cannot, therefore, be assumed. Manual systems may be less suitable for the following:

- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented or detected by control parameters that are automated.
- Control activities where the specific ways to perform the control can be adequately designed and automated.

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

- Understand internal control components that have a pervasive effect on the organization
- Understand how 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

.22 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; and
- the use of off the shelf, unmodified computer software or the use of an outside computer service organization to process significant accounting information.

.23 This section provides some guidance for the audits of medium to large businesses.

Controls Relevant to Reliable Financial Reporting and to the Audit

.24 There is a direct relationship between an entity's objectives and the internal control components it implements to provide reasonable assurance about their achievement. In addition, internal control is relevant to the entire entity or to any of its operating units or business functions. Although the entity's objectives and, therefore, controls relate to financial reporting, operations, and compliance, not all of these objectives and controls are relevant to the audit. Further, although internal control applies to the entire entity, or to any of its operating units or business functions, an understanding of internal control relating to each of the entity's operating units and business functions may not be necessary to the performance of the audit.

.25 Ordinarily, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements that are fairly presented in conformity with GAAP, including the management of risk that may give rise to a risk of material misstatement in those financial statements. However, it is not necessary to assess all controls in connection with assessing the risks of material misstatement and designing and performing further audit procedures in response to assessed risks. It is a matter of the auditor's professional judgment as to the controls or combination of controls that should be assessed. However, as stated in paragraph .115 of AU section 314, for significant risks—to the extent the auditor has not already done so—the auditor should evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented. In exercising that judgment, the auditor should consider the circumstances, the applicable component, and factors such as the following:

- Materiality
- The size of the entity
- The nature of the entity's business, including its organization and ownership characteristics
- The diversity and complexity of the entity's operations
- Applicable legal and regulatory requirements
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations

.26 Controls over the completeness and accuracy of information produced by the entity may also be relevant to the audit if the auditor intends to make use of the information in designing and performing further audit procedures. The auditor's previous experience with the entity and information obtained in understanding the entity and its environment and throughout the audit assist the auditor in identifying controls relevant to the audit.

.27 Controls relating to operations and compliance[1] objectives may, however, be relevant to an audit if they pertain to information or data the auditor may evaluate or use in applying audit procedures. For example, controls pertaining to nonfinancial data that the auditor may use in analytical procedures, such as production statistics, or 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.

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[1] An auditor may need to consider controls relevant to compliance objectives when performing an audit in accordance with AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1).

.28 An entity generally has controls relating to objectives that are not relevant to an audit and, therefore, need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as a manufacturing plant's computerized production scheduling system), but these controls ordinarily would not be relevant to the audit.

.29 Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. In obtaining an understanding of each of the components of internal control, the auditor's consideration of safeguarding controls is generally limited to those relevant to the reliability of financial reporting. For example, use of 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, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

.30 Controls relevant to the audit may exist in any of the components of internal control and a further discussion of controls relevant to the audit is included in paragraphs .67–.101 of AU section 314. In addition, paragraphs .115 and .117 of AU section 314 discuss certain risks for which the auditor should evaluate the design of the entity's controls over such risks and determine whether they have been implemented.

Internal Control Components

Understanding the Control Environment

.31 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 the client's control environment, the auditor should obtain sufficient knowledge to understand the attitudes, awareness, and actions of those charged with governance concerning the entity's internal control and its importance in achieving reliable financial reporting. In understanding the control environment, the auditor should concentrate on the implementation of controls because controls may be established but not acted upon. The following paragraphs describe some factors the auditor should consider when evaluating a client's control environment.

.32 *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.

.33 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 compliance with ethical standards is best ensured by focusing on management's *actions* and how these actions affect the entity on a day to day basis.

.34 For management's integrity and ethical values to have a positive effect on the entity, the following ordinarily should exist.

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

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

- *Segregation of personal from business funds and activities*. Many small business owners mix their personal and business activities, for example, the company may pay the owner's credit card bills even if they contain nonbusiness expenditures. The auditor might 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 a 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 their auditor's 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 the following:

— 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 the following:

— 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 nonrecurring and nonstandard transactions or events that otherwise might be handled by the financial reporting information system. The auditor might consider whether management has provided guidance on the situations and frequency with which intervention of established controls is appropriate. It is a best practice for management interventions to be documented and explained.

.36 *Commitment to Competence*. Competence reflects 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.

.37 *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; and*
- *teaching Mrs. Jones important basic control functions such as bank reconciliations.*

.38 *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 managing business risks;
- attitudes and actions toward financial reporting and tax matters; and
- attitudes and actions toward information processing and accounting functions and personnel.

.39 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, the auditor may be concerned about the client's unduly aggressive attitude toward financial reporting. Not only might this cause the auditor to assess control risk as high for some or all assertions, but it may heighten concerns about irregularities affecting certain assertions.

.40 However, a dominant owner-manager does not necessarily cause the auditor to assess control risk as high.

.41 *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*.

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

.43 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.

.44 *Assignment of Authority and Responsibility*. The assignment of authority and responsibility includes, among other things, 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

.45 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.

.46 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.

.47 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.

.48 *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 of 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 west 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*.

.49 *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*.

.50 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.

.51 *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 can 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.

.52 *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, because 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*.

.53 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.

.54 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.

.55 *Participation of those charged with governance*. An entity's control consciousness is significantly influenced by those charged with governance. As defined in paragraph .03 of AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), *those charged with governance* means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility). For entities with a board of directors, this term encompasses the terms *board of directors* or *audit committee*. For small business entities, those charged with governance may not include any independent or outside members. Please refer to paragraphs .80–.82 for additional discussion of how the participation of those charged with governance applies to medium and large businesses.

Risk Assessment

.56 An entity's risk assessment process for financial reporting purposes is its identification, analysis, and management of risks relevant to the preparation of reliable financial statements in conformity with GAAP. 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.

.57 Risks relevant to financial reporting include events and circumstances that may adversely affect the company's ability to initiate, authorize, record, process, and report financial data. Once risks are identified, management considers their significance, the likelihood of their occurrence, and how they should generally 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.

.58 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 generally should consider the control activities they performed and who will perform them going forward. Steps ordinarily 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 generally 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 generally 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.

.59 The auditor's 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.

Control Activities

.60 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.

.61 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, change, 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 paragraphs .87–.91.
- *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 paragraphs .128–.136 for further discussion and guidance.

.62 You should consider the knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities. An audit does not require an understanding of all the control activities related to each class of transactions, account balance, and disclosure in the financial statements or to every relevant assertion. Ordinarily, control activities that may be relevant to an audit include those relating to authorization, segregation of duties, safeguarding of assets, and asset accountability, including, for example, reconciliations of the general ledger to the detailed records. The auditor should obtain an understanding of the process of reconciling detail to the general ledger for significant accounts.

.63 In obtaining an understanding of control activities, the auditor's primary consideration is whether, and how, a specific control activity, individually or in combination with others, prevents or detects and corrects material misstatements in classes of transactions, account balances, or disclosures. Control activities relevant to the audit are those for which the auditor considers it necessary to obtain an understanding in order to assess risks of material misstatement at the assertion level and to design and perform further audit procedures responsive to the assessed risks. The auditor's emphasis is on identifying and obtaining an understanding of control activities that address the areas where you consider that material misstatements are more likely to occur. When multiple control activities achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to that objective.

.64 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, authorize, record, process, and report transactions or other financial data. These controls help ensure that transactions have 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.

.65 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.

.66 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, change, and maintenance; access security; and application system acquisition, development, and maintenance. Though ineffective general controls do not, by themselves, cause misstatements, they may permit application controls to operate improperly and allow misstatements to occur and not be detected. For example, if there are weaknesses in the general controls over access security, and applications are relying on these general controls to prevent unauthorized transactions from being processed, such a general control weakness may have a more severe effect on the effective design and operation of the application control. General controls should be assessed in relation to their effect on applications and data that become part of the financial statements. For example, if no new systems are implemented during the period of the financial statements, weaknesses in the general controls over systems development may not be relevant to the financial statements being audited.

.67 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.

.68 The auditor should consider whether the entity has responded adequately to the risks arising from IT by establishing effective controls, including effective general controls upon which application controls depend. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process.

Information and Communication Systems

.69 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, authorize, 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. Authorization includes the process of approving transactions by the appropriate level management. 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 measuring and reviewing the entity's financial performance and in other functions.

.70 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; and
- present properly the transactions and related disclosures in the financial statements.

.71 The financial reporting information system is an integral part of an entity's information and communication system. The auditor's consideration of the system is often made at the individual account and classes of transaction level. See paragraphs .112–.127 for additional guidance.

.72 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.

.73 The auditor should obtain sufficient knowledge of the information system, including the related business processes 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, authorized, 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, authorizing, recording, processing, and reporting transactions;
- how the information system captures other events and conditions that are significant to the financial statements; and
- the financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

.74 When IT is used to initiate, authorize, 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.

.75 The auditor also should obtain an understanding of how the incorrect processing of transactions is resolved. For example, such understanding might include whether there is an automated suspense file, how it is used by the entity to ensure that suspense items are cleared out on a timely basis, and how system overrides or bypasses to controls are processed and accounted for.

.76 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 following:

- *Entering transaction totals into the general ledger (or equivalent record)*. 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.
- *Initiating, authorizing, recording, and processing 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 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 the use of computer assisted techniques.
- *Initiating and recording recurring and nonrecurring adjustments to the financial statements.* These are procedures relating to adjustments and reclassifications that are not reflected in formal journal entries.
- *Combining and consolidating general ledger data*. This includes procedures to combine detailed general ledger accounts, prepare the trial balance, and prepare consolidated financial data (for example, transferring general ledger data and adjusting journals into a consolidation system or spreadsheet; performing consolidation routines; and reconciling and reviewing consolidated financial data, including footnote data).
- *Preparing financial statements and disclosures*. These are procedures designed to ensure that information required to be presented and disclosed is accumulated, recorded, processed, summarized, and appropriately reported in the financial statements.

Monitoring

.77 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.

.78 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 generally should have a basis for believing the data is 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

.79 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

.80 The control consciousness of a medium or large business is influenced significantly by those charged with governance. As defined previously, those charged with governance means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. Those charged with governance encompasses the term *board of directors* and *audit committee* used elsewhere in this section. Because of its importance, an active and involved board of directors—possessing an appropriate degree of management, technical, and other expertise coupled with the necessary stature and mind-set so that it can adequately perform the necessary governance, guidance, and oversight responsibilities—is critical to effective internal control.

.81 Factors that influence the effectiveness of those charged with governance include the following:

- 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

.82 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

.83 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, the auditor 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; and
- access to records and any limitations on the scope of their activities.

.84 After obtaining an understanding of the internal audit function, the auditor 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 AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1).

.85 You may also request direct assistance from the internal auditors. Paragraph .27 of AU section 322 provides guidance on using internal auditors to provide direct assistance to the auditor.

Formal Policies

.86 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

.87 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.

.88 *Jones Grocery has a stand-alone, state of the art PC at its main store. One other store has a computer—an Apple Macintosh that 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.*

.89 In gaining an understanding of how computers are used in the business, the auditor may 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

.90 Companies ordinarily should take steps to ensure they have compatible hardware and software. The use of compatible software reduces the risk of error, because there will be no need to transfer data from one format into another. Even small businesses generally should have a coherent plan for the purchase of computer hardware and software. If the business is growing, management will typically plan for the upgrade of the processor, random access memory (RAM), or hard disk storage.

.91 *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.*

.92 *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 other sorts 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?*

.93 Entities ordinarily 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 themselves millions of times and filling all available memory or disk storage.

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

- Obtaining recognized software from reputable sources and only accepting delivery of the software in the manufacturer's sealed package.
- Making 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.
- Prohibiting the use of unauthorized programs introduced by employees.
- Prohibiting the downloading of untested software from sources such as dial-up bulletin boards.
- Using virus protection software to screen for virus infections.

Physical Security

.95 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.

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

Logical Access

.97 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.

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

.99 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 generally should be controlled or monitored carefully.

User Controls Over Computer Service Organization Applications

.100 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 AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1).

.101 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) typically maintains 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.

.102 *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, and benefits, among others, 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

.103 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.

.104 Medium and large businesses are also typically characterized by a separate management information services department with formally defined job descriptions and responsibilities.

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

.106 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.

.107 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

.108 *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.

.109 *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.

.110 *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. The auditor 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; and
- adequate access controls reduce the risk of unauthorized changes to the program and data files.

.111 The following table summarizes computer general control activities.

Area	*Control Objectives*	*Example Controls*
Program development	• Controls ensure that new applications systems are suitably authorized, designed, and tested	• Users are involved in the design and approval of systems • Checkpoints where users review the completion of various phases of the application • Development of test data and testing of the program • User involvement in the review of tests of the program • Adequate procedures to transfer programs from development to production libraries

(continued)

Area	*Control Objectives*	*Example Controls*
Program changes	• Controls over changes to existing programs and systems ensure that modifications to application programs are suitably approved, designed, tested, and implemented	• Same as program development • User involvement • Adequate testing • Adequate transfer activities • Segregation of duties between programmers and production libraries
Computer operations	• Controls ensure that application programs are used properly and that proper data files are used during processing	• Review of lists of regular and unscheduled batch jobs by operations management • Use of menu-driven job control instruction sets • Jobs executed only from the operator's terminal • Adequate procedures for managing and backing up data and program files
Access	• Controls should prevent or detect unauthorized changes to programs and to data files supporting the financial statements	• Programmers have limited access to production programs, live data files, and job control language • Operators have limited access to source code and individual elements of data files • Users have access only to defined programs and data files

Obtaining an Understanding of Significant Account Balances and Transaction Cycles

.112 As discussed in paragraph .83 of AU section 314, the auditor should obtain sufficient knowledge of the information system, including the related business processes 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, authorized, 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; and
- the financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

.113 ***Accounting Processing***. In obtaining an understanding of how a client processes accounting information—from the initiation of the transaction to its inclusion in the financial statements—the auditor may focus on how the computer is used to process data and 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.

.114 *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 (for example, receipt of goods, sales, and spoilage) 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.*

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

.116 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.

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

.118 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; and
- accumulate footnote information (for example, a spreadsheet may be used to calculate the five-year debt maturity disclosure).

.119 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.

.120 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.

.121 To address these concerns and to ensure the end user applications process data completely and accurately, the auditor may 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; and
- support meaningful user reconciliations.

.122 *Accounting Records, Supporting Information, and Specific Accounts*. In general, the auditor may identify the following for a client's significant accounts and transactions:

- Source documents
- Documents converted to computer media
- 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

.123 A client's accounting systems may create many documents, files, and reports that are useful for managing the organization; however, not all will be relevant to the financial statements.

.124 *At Jones Grocery, the sales analysis report described in paragraph .114* 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.

.125 *Other Significant Events and Conditions*. The entity's information system may capture 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.

.126 *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*.

.127 *Financial Reporting Process*. When gaining an understanding of the financial reporting process, the auditor may determine the extent of client procedures to prepare accounting estimates (when significant accounting estimates are called for) and information for significant disclosures. The auditor may also 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

.128 Small businesses are typically characterized by the following:

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

.129 These characteristics may pose unique risks to the entity.

.130 In general, duties should be divided 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 could be divided.

.131 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—which may be the case on occasion—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.

.132 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.

.133 Management *override* is different from management *intervention*. *Management intervention* is discussed in paragraph .35 and is described as the overrule of internal control for legitimate purposes. For example, management intervention is usually necessary to deal with nonrecurring and nonstandard transactions or events that otherwise might be handled by the system.

.134 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.

.135 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
- To hide lack of compliance with legal requirements

Override practices include deliberate misrepresentations to bankers, lawyers, accountants, and vendors, as well as intentionally issuing false documents such as sales invoices.

.136 When gaining an understanding of internal control, the auditor assesses the risk of management override.

Assessing Internal Control Strengths and Weaknesses

.137 When obtaining an understanding of internal control, the auditor may 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.

.138 Internal control strengths may indicate account balances, transaction classes, or assertions where you can assess control risk at low or moderate.[2] Internal control weaknesses usually indicate areas where substantive procedures may be 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 sufficient competent audit evidence.

.139 In rare circumstances, the auditor's 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 the auditor 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 the auditor to conclude it is unlikely that sufficient appropriate audit evidence will be available to support an opinion on the financial statements.

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[2] Control risk may be assessed in quantitative terms, such as percentages, or in qualitative terms such as high, medium, or low risk.

.140 If the auditor determines the entity is unauditable, the auditor should consider withdrawing from the engagement.

Practical Guidance

Readers may refer to appendix M, "Illustrative Audit Documentation Case Study: Young Fashions, Inc.," of the AICPA Audit Guide, Assessing and Responding to Audit Risk in a Financial Statement Audit, for examples of how to document your understanding of internal control. Appendix M contains several subappendixes (appendix M-1–M-6). Those that are particularly relevant to internal control include the following:

- Appendix M-2, "Young Fashions: Evaluation of Entity–Level Controls," provides example documentation of the auditors evaluation of entity-level controls, except for IT general controls. Appendix M-2 illustrates how to document your understanding of the controls relevant to the audit, including (1) an evaluation of whether the design of the control, individually or in combination, is capable of effectively preventing or detecting and correcting material misstatements and (2) a determination of whether the control exists and the entity is using it.
- Appendix M-2-1, "Young Fashions: Procedures Performed to Evaluate Entity-Level Controls," provides illustrative documentation for the risk assessment and other procedures an auditor performs to gather information about internal control and the source of that information.
- Appendix M-3, "Young Fashions: Understanding of Internal Control—IT General Controls," provides example documentation of the auditors evaluation of IT general controls.
- Appendix M-4, "Young Fashions: Evaluation of Activity-Level Controls—Wholesale Sales," provides example documentation of an evaluation of activity-level controls. This case study presents only one class of transactions, sales. In practice, the auditor would evaluate activity-level controls for each significant class of transactions.

[*The next page is 5001.*]

AAM Section 5000
Designing and Performing Further Audit Procedures

> The material included in these sections on designing and performing further audit procedures is presented for illustrative purposes only. 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 assessed risks of material misstatement.
>
> This manual is a nonauthoritative practice aid. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate. Please also note that this manual does not deal with specialized industry issues; refer to applicable AICPA Audit and Accounting Guides for industry guidance.

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AAM Section 5100

Designing Further Audit Procedures

Audit Procedures for Obtaining Audit Evidence

.01 In order to draw reasonable conclusions on which to base the audit opinion, auditors should obtain audit evidence by performing audit procedures to

- obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels (audit procedures performed for this purpose are referred to as *risk assessment procedures*);
- when necessary or when the auditor has determined to do so, test the operating effectiveness of controls in preventing or detecting material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as *tests of controls*); and
- detect material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as *substantive procedures* and include tests of details of classes of transactions, account balances, and disclosures, and substantive analytical procedures).

.02 The auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

.03 Tests of controls are necessary in two circumstances. When the auditor's risk assessment includes an expectation of the operating effectiveness of controls, the auditor should test those controls to support the risk assessment. In addition, when the substantive procedures alone do not provide sufficient appropriate audit evidence, the auditor should perform tests of controls to obtain audit evidence about their operating effectiveness. See AAM section 5200 for additional guidance on performing tests of controls.

.04 As described in AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), the auditor should plan and should perform substantive procedures to be responsive to the related planned level of detection risk, which includes the results of tests of controls, if any. The auditor's risk assessment is judgmental, however, and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations in internal control, including the risk of management override, the possibility of human error, and the effect of systems changes. Therefore, regardless of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. See AAM section 5300 for additional guidance on performing substantive procedures.

Linking the Assessed Risks to the Design of Further Audit Procedures

.05 As discussed in AAM section 3130, the auditor's risk assessment process culminates with the articulation of the account balances, classes of transactions, or disclosures where material misstatements are most likely to occur and—even more specifically—how the misstatements may occur and the assertions that are likely to be misstated. This assessment of the risks of misstatement, which relates identified financial reporting risks to what can go wrong at the assertion level, provides a basis for the design of further audit procedures.

.06 To reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor.

Overall Responses to Risks at the Financial Statement Level

.07 The auditor's audit response to financial statement level risks should be responsive to the assessed risk. The same is true for responses to risk at the account, assertion level, or both. It is critical that the auditor's audit procedures are linked clearly and responsive to the assessment. This linkage between risk assessment and audit procedures is part of the audit strategy and audit plan, and it should be documented. The following paragraph describes some important characteristics of financial statement level risks. The purpose of these descriptions is to help the auditor bridge between the assessment of financial statement level risks and the subsequent response.

.08 Characteristics of financial statement level risks that are relevant for audit purposes include the following:

- *Financial statement level risks can affect many assertions*. By definition, financial statement level risks may result in material misstatements of several accounts or assertions. For example, a lack of controls over journal entries increases the risk that an inappropriate journal entry could be posted to the general ledger as part of the period-end financial reporting process. The posting of an inappropriate journal entry may not be isolated to one general ledger account but potentially could affect any account. In general, overall audit risk increases when the magnitude or scope of an identified risk of misstatement is not known.
- *Assessing financial statement-level risks requires significant judgment*. Ultimately, the auditor relates identified risks of misstatement to what can go wrong. For example, suppose that while performing risk assessment procedures to gather information about the control environment, the auditor discovered weaknesses relating to the hiring, training, and supervision of entity personnel. These weaknesses result in an increased risk of a misstatement of the financial statements, but it will be a matter of the auditor's professional judgment to determine the following:
    - The accounts and relevant assertions that could be affected
    - The likelihood that a financial statement misstatement will result from the increased risk
    - The significance of any misstatement
- *Risks at the Financial Statement Level May Not be Identifiable With Specific Assertions*. Control weaknesses at the financial statement level can render well-designed activity-level controls ineffective. For example, a significant risk of management override can potentially negate existing controls and procedures at the activity level in many accounts and for many assertions. Linking such a risk to specific accounts and assertions may be very difficult and may not even be possible. As another example, a client may have excellent data input controls at the application level. But if poorly designed IT general controls allow many unauthorized personnel the opportunity to access and inappropriately change the data, the well-designed input controls have been rendered ineffective. Also, strengths in financial statement-level controls such as an overall culture of ethical behavior may increase the reliability of controls that operate at the activity level. Determining the extent to which financial statement level controls affect the reliability of specific activity level controls (and, therefore, the assessment of the risks of material misstatement) is subjective and may vary from client to client.

.09 Due to the unique characteristics of financial statement level risks, it may not be possible to correlate all of these risks to a finite set of assertions. For example, a weakness in control environment may affect all or mostly all of the accounts, classes of transactions, or disclosures and the relevant assertions. To respond appropriately to these types of financial statement level risks, the auditor may need to reconsider the overall approach to the engagement. The following paragraph provides examples of overall responses to risks at the financial statement level that have a pervasive effect on the financial statements and cannot necessarily be mapped to individual assertions.

.10 The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include the following:

- Emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence.
- Assigning more experienced staff or those with specialized skills or using specialists.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed and in selecting individual items for testing.
- Making general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date. One could also focus more time and attention on audit areas more closely associated with the risk.

.11 The assessment of the risks of material misstatement at the financial statement level is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to perform some audit procedures at an interim date rather than at period end. If there are weaknesses in the control environment, the auditor should consider an appropriate response. For example, the auditor could perform audit procedures as of the period end rather than at an interim date, seek more extensive audit evidence from substantive procedures, modify the nature of audit procedures to obtain more persuasive audit evidence, or increase the number of locations to be included in the audit scope.

.12 Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach) or an approach that uses tests of controls as well as substantive procedures (combined approach).

.13 Paragraphs .13 and .50 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), describe the overall responses the auditor may take in response to your assessment of the risk of material misstatement due to fraud. When determining an overall audit response, the auditor may consider the assessment of fraud risk concurrently with the assessment of the risk of material misstatement due to error. The auditor can develop one overall response that is appropriate for both kinds of risks.

Audit Procedures Responsive to Risks of Material Misstatement at the Relevant Assertion Level

.14 Further audit procedures provide important audit evidence to support the auditor's audit opinion. These procedures consist of tests of controls and substantive tests.

.15 The auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the risk assessments.

.16 In designing further audit procedures, the auditor should consider such matters as the following:

- The significance of the risk and the likelihood that a material misstatement will occur. In general, the more significant (in terms of likelihood and magnitude) the risk, the more reliable and relevant audit evidence should be.
- The characteristics of the class of transactions, account balance, or disclosure involved, which will help determine the nature, timing, and extent of procedures available to the auditor. For example, the gross accounts receivable balance comprises transactions with third parties, which means the auditor can contact these external parties to confirm the transactions or individual account balances. On the other hand, the allowance for doubtful accounts is an estimate prepared internally, which does not lend itself to confirmation but to other substantive tests.
- The nature of the specific controls used by the entity, in particular, whether they are manual or automated.
- Whether the auditor expects to obtain audit evidence to determine if the entity's controls are effective in preventing or detecting material misstatements.

The nature of the audit procedures is of most importance in responding to the assessed risks.

.17 The auditor's assessment of the identified risks at the relevant assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. In some cases, the auditor may determine that performing only substantive procedures is appropriate for specific relevant assertions and risks. In those circumstances, the auditor may exclude the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion or because testing the operating effectiveness of controls would be inefficient. However, the auditor needs to be satisfied that performing only substantive procedures for the relevant assertions would be effective in reducing detection risk to an acceptably low level. The auditor often will determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach.

.18 Regardless of the audit approach selected, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Because effective internal controls generally reduce, but do not eliminate, risk of material misstatement, tests of controls reduce, but do not eliminate, the need for substantive procedures. In addition, analytical procedures alone may not be sufficient in some cases. For example, when auditing certain estimation processes such as examining the allowance for doubtful accounts, the auditor may perform substantive procedures beyond analytical procedures (for example, examining cash collections subsequent to period end) due to the risk of management override of controls or the subjectivity of the account balance.

.19 In the case of very small entities, there may not be many control activities that could be identified by the auditor. For this reason, the auditor's further audit procedures are likely to be primarily substantive procedures. In such cases, in addition to the matters referred to in the preceding paragraph .16, the auditor should consider whether in the absence of controls it is possible to obtain sufficient appropriate audit evidence.

Nature of Further Audit Procedures

.20 The nature of further audit procedures refers to the following:

- Their purpose, that is, tests of controls or substantive procedures (or dual purpose tests) and whether they are designed to test for overstatement, understatement, or both.
- Their type, such as the following:
  - — Inspection
  - — Observation

- — Inquiry
- — Confirmation
- — Recalculation
- — Reperformance
- — Analytical procedures (including scanning)

Table 1 provides additional guidance on each of these procedures.

Table 1

Types of Audit Procedures

Type of Procedure	*Definition*	*Additional Guidance*
Inspection of documents	Inspection of documents involves examining records or documents, whether internal or external, in paper form, electronic form, or other media.	• This procedure provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal documents, on the effectiveness of the controls over their production. • Some documents represent direct audit evidence of the existence of an asset but not necessarily about ownership or value. • Inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting principles, such as revenue recognition. • Some forms of documents are less persuasive than others. For example, faxes and copies may be less reliable than original documents.
Inspection of tangible assets	Inspection of tangible assets consists of physical examination of the assets.	• This procedure may provide audit evidence relating to existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. • Inspection of individual inventory items ordinarily accompanies the observation of inventory counting.
Observation	Observation consists of looking at a process or procedure being performed by others.	• This procedure provides audit evidence about the performance of a process or procedure but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed.

(continued)

Type of Procedure	*Definition*	*Additional Guidance*
Confirmation	Confirmation is the process of obtaining a representation of information or of an existing condition directly from a knowledgeable third party.	• This procedure — frequently is used in relation to account balances and their components but need not be restricted to these items; — can be designed to ask if any modifications have been made to an agreement, and if so, what the relevant details are; and — also is used to obtain audit evidence about the absence of certain conditions (for example, the absence of an undisclosed agreement that may influence revenue recognition). • See AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), for further guidance on confirmations.
Recalculation	Recalculation consists of checking the mathematical accuracy of documents or records.	• This procedure can be performed through the use of information technology, for example, by applying a data extraction application or other computer assisted audit techniques (CAATs).
Reperformance	Reperformance is the auditors independent execution of procedures or controls that were originally performed as part of the entity's internal control	• This procedure may be performed either manually or through the use of CAATs, for example, reperforming the aging of accounts receivable.

Inquiry

.21 Inquiry consists of seeking information of knowledgeable individuals. These individuals may be involved in the financial reporting process or outside of that process; they may be internal or external to the company. Inquiry is used extensively throughout the audit and often is complementary to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Asking questions of knowledgeable individuals is only part of the inquiry process. Evaluating the responses to inquiries is an equally integral part of the process.

.22 Inquiry normally involves such actions as the following:

- Considering the knowledge, objectivity, experience, responsibility, and qualifications of the individual to be questioned
- Asking clear, concise, and relevant questions
- Using open or closed questions appropriately
- Listening actively and effectively
- Considering the reactions and responses and asking follow-up questions

- Evaluating the response

See appendix K, "Suggestions for Conducting Inquiries," of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* for further guidance on performing inquiries.

.23 Responses to inquiries may provide the auditor with information he or she did not previously possess or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information the auditor has obtained, such as information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures. The auditor should resolve any significant inconsistencies in the information obtained.

.24 The auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient appropriate audit evidence to detect a material misstatement. Moreover, inquiry alone is not sufficient to test the operating effectiveness of controls.

.25 In some instances, the auditor may need to obtain evidence about management's intended actions, for example, when obtaining evidence to support management's classification of investments as either trading, available for sale, or hold to maturity. To corroborate management's responses to questions regarding their intended future action, the following may provide relevant information.

- Management's past history of carrying out its stated intentions.
- Management's stated reasons for choosing a particular course of action.
- Management's ability to pursue a specific course of action.

.26 In some cases, the auditor should obtain replies to inquiries in the form of written representations from management. For example, when obtaining oral responses to inquiries, the nature of the response may be so significant that it warrants obtaining written representation from the source. See AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), for further guidance on written representations.

Substantive Analytical Procedures

.27 Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted 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 risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control

c. As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions

d. As an overall review of the financial information in the final review stage of the audit

.28 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

.29 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 may be used whenever practical.

.30 Paragraph .05 of AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), 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, gross margin information.
>
> *e.* Relationships of the financial information with relevant nonfinancial information.

.31 Whenever analytical procedures are applied as substantive tests, the auditor may apply the following procedures:

- Consider whether the relationship is plausible and predictable.
- Consider whether the data used for the comparison is reliable.
- 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.

.32 AU section 329 states that analytical procedures should be performed in the planning and overall review stages of all audits. See AU section 329 and AAM section 3155 for further guidance on analytical procedures.

The Selection of Audit Procedures

.33 The auditor's selection of audit procedures is based on the risk of material misstatement. The higher the auditor's assessment of risk, the more reliable and relevant the audit evidence sought by the auditor from substantive procedures is. This determination of the requisite reliability and relevance of audit evidence may affect both the types of audit procedures to be performed and their combination. For example, the auditor may confirm the completeness of the terms of a contract with a third party, in addition to inspecting the document and obtaining management's representation. This combination of several procedures would result in more reliable and relevant audit evidence than obtained by performing only one procedure.

.34 In determining the audit procedures to be performed, the auditor should consider the underlying reasons for the assessment of the risk of material misstatement at the relevant assertion level for each class of transactions, account balance, and disclosure. These underlying reasons relate to both the inherent and control risks related to the assertion. For example, if the auditor assessed risk of material misstatement to be low that a material misstatement might occur because of low inherent risk, the auditor may determine that substantive analytical procedures alone may provide sufficient appropriate audit evidence. On the other hand, if the auditor expects that there is a lower risk of material misstatement because the client has effective controls and the auditor intends to design substantive procedures based on relying on the effective operation of those controls, then the auditor should perform tests of controls to obtain audit evidence about their operating effectiveness.

.35 The auditor should obtain audit evidence about the accuracy and completeness of information produced by the entity's information system when that information is used in performing audit procedures. For example, if the auditor uses nonfinancial information or budget data produced by the entity's information system in performing audit procedures, such as substantive analytical procedures or tests of controls, the auditor should obtain audit evidence about the accuracy and completeness of such information.

Timing of Further Audit Procedures

.36 Timing refers to when audit procedures are performed or the period or date to which the audit evidence applies. The auditor may perform tests of controls or substantive procedures:

- At an interim date
- At period end
- After period end, in those instances where the procedure cannot be performed prior to or at year end (for example, agreeing the financial statements to the accounting records)

.37 The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to or at the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters. If the auditor performs tests of the operating effectiveness of controls or substantive procedures before period end, the auditor should consider the additional evidence that is necessary for the remaining period.

.38 In considering when to perform audit procedures, the auditor should also consider such matters as the following:

- The assessed risk of misstatement. In general, the higher the risk, the more likely it is that the auditor will perform procedures nearer to or at the period end.
- The control environment. In general, the more effective the control environment, the more likely it is that the auditor will be able to perform tests as of an interim date.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.

Extent of Further Audit Procedures

.39 Extent refers to the quantity of a specific audit procedure to be performed, for example, a sample size or the number of observations of a control activity. The extent of an audit procedure is determined by the judgment of the auditor after considering the following:

- Tolerable misstatement
- Assessed risk of material misstatement

- Degree of assurance the auditor plans to obtain

.40 In particular, the auditor may increase the extent of audit procedures as the risk of material misstatement increases. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk and reliable; therefore, the nature of the audit procedure is the most important consideration.

.41 The AICPA Audit Guide *Audit Sampling* provides additional guidance on sampling for substantive testing.

Documentation

.42 The auditor should document the overall responses to address the assessed risks of misstatement at the financial statement level and the linkage of those procedures with the assessed risks at the relevant assertion level. The manner in which these matters are documented is based on the auditor's professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

[*The next page is 5201.*]

AAM Section 5200

Performing Tests of Controls

.01 The auditor should perform tests of controls when the auditor's risk assessment[1] includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level.

.02 When, in accordance with paragraph .117 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the auditor has determined that it is not possible or practicable to reduce the detection risks at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, he or she should perform tests of controls to obtain audit evidence about their operating effectiveness. For example, as discussed in paragraphs .119–.120 of AU section 314, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the relevant assertion level when an entity conducts its business using information technology (IT) and no documentation of transactions is produced or maintained, other than through the IT system.

.03 Tests of the operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent or detect a material misstatement in a relevant assertion. Paragraphs .106–.108 of AU section 314 discuss the identification of controls at the relevant assertion level likely to prevent or detect a material misstatement in a class of transactions, account balance, or disclosure.

.04 Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor should determine that the relevant controls exist and that the entity is using them. When performing tests of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about

- how controls were applied at relevant times during the period under audit,
- the consistency with which they were applied, and
- by whom or by what means they were applied.

If substantially different controls were used at different times during the period under audit, the auditor should consider each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

General Considerations When Testing Controls

Sources of Audit Evidence About Internal Control Effectiveness

.05 The audit evidence used to provide support for the auditor's conclusion about the operating effectiveness of controls during the audit period may come from a variety of sources, including the following:

- Tests of controls performed during the current period.
- Risk assessment procedures performed during the current period.
- Evidence provided in a Type 2 SAS 70 report (see AU section 324, *Service Organizations* [AICPA, *Professional Standards*, vol. 1]).

[1] The auditor's strategy reflects the level of assurance the auditor plans to obtain regarding controls.

- Evidence obtained from the performance of procedures in previous audits.
- The information gathered and conclusions reached as part of the auditor's quality control procedures for client acceptance and continuance. For example, client acceptance procedures may include inquiries of attorneys, bankers, or others in the business community about client management that provide insight into their
  - — competence,
  - — integrity,
  - — operating philosophy, and
  - — ethical values.

Risk Assessment Procedures vs. Tests of Controls

.06 Risk assessment procedures allow the auditor to evaluate the design effectiveness of internal controls for the purpose of assessing risks of material misstatement. Tests of controls build on the auditor's evaluation of design effectiveness and allow the auditor to assess the operating effectiveness of controls during the operating period. The results of the auditor tests of controls are used to design substantive procedures.

.07 Although some risk assessment procedures that the auditor performs to evaluate the design of controls and to determine that they have been implemented may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, a walkthrough or the observation of the performance of a control may provide evidence about the operating effectiveness of controls. In such circumstances, the auditor should consider whether the audit evidence provided by those audit procedures is sufficient.

Evidence of Operating Effectiveness of Controls at a Service Organization

.08 A Type 2 service auditor's report may provide evidence about the operating effectiveness of controls at a service organization. However, controls over the information provided to the service organization may still need to be assessed.

Evaluating the Effectiveness of Complementary Controls

.09 When designing tests of controls, typically the auditor will focus first on testing control activities, because the control activities component of internal control is the one most directly related to the assertion. For example, physically counting goods that have been received and comparing the quantity and description to the vendor's packing slip is directly related to both the existence and valuation of inventory.

.10 However, in addition to testing the controls that relate directly to the assertion, the auditor should consider the need to obtain audit evidence supporting the effective operation of the complementary controls upon which the effectiveness of the direct control depends.

.11 When considering the need to test complementary controls, the auditor may consider the following:

- *The significance of the complementary control to the effective functioning of the direct control.* As the effectiveness of the direct control becomes more dependent on the complementary control, the auditor's need to test the indirect control increases.
- *The relative significance of the audit evidence of the complementary control to the auditor's conclusion on the effectiveness of the direct control.* The auditor's conclusion about the operating effectiveness of a control activity is supported by a combination of evidence about (i) the operating effectiveness of the direct control activity itself and (ii) the operating effectiveness of other, complementary controls upon which the effectiveness of the direct control depends. In some instances, the auditor may be

able to support a conclusion based primarily on tests of the direct control, with little evidence about the operating effectiveness of the related complementary controls. In other instances (for example, IT application controls), the auditor's conclusion may be based primarily on tests of the comple mentary controls and little on tests of the direct control. In those situations where you rely significantly on the operating effectiveness of the complementary control, the auditor might obtain more sufficient and adequate audit evidence to support the conclusion on the operating effectiveness of the indirect control, for example, the monitoring of the performance of the reconciliation.

- *The degree of reliability required of the audit evidence obtained about internal control operating effectiveness.* Testing the complementary control increases the reliability of the audit evidence obtained about the operating effectiveness of the direct control. For example, the auditor may test four month-end reconciliations and draw a conclusion about the effectiveness of those reconciliations for an entire 12-month period. If the auditor has tested the operating effectiveness of the complementary controls related to the reconciliation, the conclusion about the effectiveness of the reconciliation during the period the auditor did not test will be more reliable than if the auditor did not test the complementary controls.
- *Evidence of operating effectiveness that may have been obtainedas part of obtaining an understanding of the design and implementation of the complementary controls.* When performing risk assessment procedures to obtain an understanding of internal control, the auditor may obtain some information about the operating effectiveness of the complementary controls that are indirectly related to an assertion. For example, risk assessment procedures may provide the auditor with some evidence about the operating effectiveness of portions of the control environment. This information about operating effectiveness may be limited, but nevertheless, it may be sufficient for the purpose of drawing a conclusion about the operating effectiveness of the direct control.

.12 When testing complementary controls, the auditor may choose not to test the operating effectiveness of the entire component to which the complementary control pertains, but may limit the tests to those elements of the component that have an immediate bearing on the effectiveness of the direct control. For example, when testing controls over purchasing to place moderate reliance on them, the auditor may consider the need to test the control environment or IT general controls relating to the entire entity beyond the design and implementation assessment procedures the auditor already has performed. If practical, the auditor may limit the tests to those aspects of the control environment or IT general controls that have a direct bearing on the financial statement assertions related to purchasing. To place high reliance on the controls, the auditor may often need to gather additional evidence concerning the IT general controls and overall control environment to support high reliance on the purchasing controls.

The Relationship Between Tests of Controls and Substantive Tests

.13 There is an inverse relationship between the audit evidence to be obtained from substantive tests and that obtained from tests of controls. As the sufficiency and adequacy of the audit evidence obtained from tests of controls increases, the sufficiency and adequacy of the audit evidence required from substantive tests generally decreases. For example, in circumstances when the auditor adopts an approach consisting primarily of tests of controls, in particular related to those risks where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures, the auditor should perform tests of controls to obtain a high level of assurance about their operating effectiveness.

.14 On the other hand, the more audit evidence from substantive tests, the less audit evidence from tests of controls would be necessary. In many instances, the nature and extent of substantive tests alone may provide sufficient, adequate evidence at the assertion level, which would make the testing of control effectiveness (beyond assessing the design and implementation of the related controls) unnecessary.

A Financial Statement Audit vs. an Examination of Internal Control

.15 Testing the operating effectiveness of internal control to support an opinion on the financial statements is different from testing controls to support an opinion on the effectiveness of the internal control system.

.16 In an attestation engagement to examine the effectiveness of internal control, the audit evidence obtained from the tests of internal control is the only evidence the auditor has to support an opinion. In contrast, when performing an audit of the financial statements, the auditor ordinarily performs both tests of controls and substantive tests. The objective of the tests of controls in a financial statement audit is to assess the operating effectiveness of controls and incorporate this assessment into the design of the nature, timing, and extent of substantive procedures. Thus, when testing controls in a financial statement audit, the auditor has flexibility in determining not only whether to test controls, and if so which controls to test, but also the level of effectiveness of those controls that is necessary to provide the desired level of support for an opinion on the financial statements.

Determining the Nature of the Tests of Controls

.17 The nature of the procedures the auditor performs to test controls has a direct bearing on the relevance and reliability of audit evidence. When responding to assessed risks of material misstatement, the nature of the audit procedures is of most importance. Performing more tests or conducting the tests closer to the period end will not compensate for a poorly designed test that lacks sufficient relevance or reliability in gathering audit evidence about the effectiveness of a control.

.18 The types of audit procedures available for obtaining audit evidence about the effectiveness of controls includes the following:

- Inquiries of appropriate entity personnel
- Inspection of documents, reports, or electronic files indicating performance of the control
- Observation of the application of the control
- Reperformance of the application of the control by the auditor

.19 The nature of the particular control influences the type of audit procedure necessary to obtain audit evidence about operating effectiveness. Documentation may provide evidence about the performance of some controls; in these situations, the auditor may inspect this documentation to obtain evidence about the operating effectiveness of the control.

.20 For other controls, complete documentation may not be available or relevant. For example, documentation of the operation may be sketchy for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed automatically by the client's IT system. In these circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation of the performance of the control or the use of computer assisted audit techniques (CAATs). Entities can be encouraged to improve weak documentation.

.21 Because of the limits of inquiry and observation, inquiry combined with inspection or reperformance ordinarily provide more reliable audit evidence than a combination of only inquiry and observation. For example, the auditor may inquire about and observe the entity's procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observation with other observations or inquiries of entity personnel, and the auditor may also inspect documentation about the operation of such controls at other times during the audit period.

Tests of IT Controls

.22 Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated control, combined with audit evidence about the operating effectiveness of IT general controls (and in particular, security and change controls) may provide substantial audit evidence about the operating effectiveness of the control during the entire audit period. That is, once the auditor has determined that an IT application control has been implemented (placed in operation), the auditor may draw a conclusion about the operating effectiveness of the IT portion of the control activity, so long as the auditor has determined that relevant IT general controls are operating effectively.

Tests of Spreadsheets

.23 The development and use of spreadsheets typically lack the controls that usually are present for formal, purchased software. Absent audit evidence indicating that appropriate general controls over spreadsheets have been implemented, the auditor might continue to test spreadsheet controls even after their implementation.

Dual Purpose Tests

.24 Some audit procedures may simultaneously provide audit evidence that both

- support the relevant assertion or detects material misstatement and
- support a conclusion about the operating effectiveness of related controls.

Tests that achieve both of these objectives concurrently on the same transaction typically are referred to as dual purpose tests. For example, the auditor may examine an invoice to determine whether it has been approved and also to provide substantive audit evidence about the existence and amount of the transaction.

.25 When performing a dual purpose test, the auditor should carefully consider whether the design and evaluation of such tests can accomplish both objectives. For example, the population of controls and the population of substantive procedures should be the same. If tests on components of a balance such as receivables are designed as dual purpose tests, only evidence of the controls operating over period-end balance items will be obtained.

.26 Furthermore, when performing such tests, the auditor should consider how the outcome of the tests of controls may affect the auditor's determination about the extent of substantive procedures to be performed. For example, if controls are found to be ineffective, the auditor should consider whether the sample size for substantive procedures should be increased from that originally planned.

Determining the Timing of Tests of Controls

.27 The timing of tests of controls affects the relevance and reliability of the resulting audit evidence. In general, the relevance and reliability of the audit evidence obtained diminishes as time passes between the testing of the controls and the end of the period under audit. For this reason, when tests of controls are performed during an interim period or carried forward from a previous audit, the auditor should determine what additional audit evidence should be obtained to support a conclusion on the current operating effectiveness of those controls.

.28 The timing of tests of controls depends on the auditor's objective:

a. When controls are tested as of a point in time, the auditor may obtain audit evidence that the controls operated effectively only at that time.

b. When controls are tested throughout a period, the auditor may obtain audit evidence of the effectiveness of the operation of the control during that period.

.29 Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the client's physical inventory counting at the period end. If, on the other hand, the auditor needs audit evidence of the effectiveness of a control over a period, audit evidence pertaining only to a point in time may be insufficient, and the auditor should supplement those tests with others that provide audit evidence that the control operated effectively during the period under audit. For example, for an automated control, the auditor may test the operation of the control at a particular point in time. The auditor then may perform tests of controls to determine whether the control operated consistently during the audit period, or the auditor may test with the intention of relying on general controls pertaining to the modification and use of that computer program during the audit period.

.30 The tests the auditor performs to supplement tests of controls at a point of time may be part of the tests of controls over the client's monitoring of controls.

Updating Tests of Controls Performed During an Interim Period

.31 The auditor may test controls as of or for a period that ends prior to the balance sheet date. This date often is referred to as the *interim date* or *interim period*. The period of time between the interim date or period and the balance sheet date often is referred to as the *remaining period*.

.32 When the auditor tests controls during an interim period or as of an interim date, the auditor should:

- obtain audit evidence about the nature and extent of any significant changes in internal control that occurred during the remaining period and
- determine what additional audit evidence should be obtained for the remaining period.

.33 To determine what additional audit evidence the auditor should obtain to update tests of controls performed in advance of the balance sheet date, the auditor should consider the following:

- The significance of the assessed risks of material misstatement at the relevant assertion level
- The specific controls that were tested during the interim period
- The degree to which audit evidence about the operating effectiveness of those controls was obtained
- The length of the remaining period
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls
- The control environment
- The volume or value of transactions processed in the remaining period

.34 When testing controls as of or during an interim period, the auditor may obtain additional audit evidence about the operating effectiveness of controls during the remaining period by performing procedures such as

- extending the testing of the operating effectiveness of controls over the remaining period or
- testing the client's monitoring of controls.

.35 For example, the auditor might perform

- inquiries and observations related to the performance of the control, the monitoring of the control, or any changes to the control during the remaining period;
- a walkthrough covering the period between the interim date and the period end; and
- the same procedures performed at interim, but directed to the period from interim to period end.

Use of Audit Evidence Obtained in Prior Audits

.36 If certain conditions are met, the auditor may use audit evidence obtained in prior audits to support the conclusion about the operating effectiveness of controls in the current audit. If the auditor plans to use evidence obtained in prior periods, the auditor should consider

- whether the use of this evidence is appropriate and
- the length of the time period that may elapse before retesting the control.

.37 The following table summarizes the factors the auditor should consider when determining whether to use audit evidence about the operating effectiveness obtained in a prior audit.

	Appropriateness of Using Evidence From Prior Audit		*Length of Time Before Retesting Control*	
	May be appropriate	*May not be appropriate*	*Longer*	*Shorter*
Effectiveness of control environment, the client's risk assessment, monitoring, and IT general controls	Effective design and operation	Evidence of poor design or operation	Effective design and operation	Evidence of poor design or operation
Risks arising from characteristics of the control	Largely automated control	Significant manual or judgmental component to control	Largely automated control	Significant manual or judgmental component to control
Changes in circumstances at the client that may require changes in controls, including personnel changes that affect application of the control	Minor changes in client circumstances, including personnel	Significant changes in client circumstances, including personnel	Minor changes in client circumstances, including personnel	Significant changes in client circumstances, including personnel
Operating effectiveness of the control	Control operated effectively in prior audit	Control did not operate effectively in prior audit	Control operated effectively in prior audit	Control did not operate effectively in prior audit
Risks of material misstatement	Low risk of material misstatement for relevant assertion	High risk of material misstatement for relevant assertion	Low risk of material misstatement for relevant assertion	High risk of material misstatement for relevant assertion
Extent of reliance on the control to design substantive procedures	Low reliance on the control	High reliance on the control	Low reliance on the control	High reliance on the control

.38 If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should

- obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit and
- perform audit procedures to establish the continuing relevance of audit evidence obtained in the prior audit.

.39 Even when the auditor uses audit evidence about the operating effectiveness of controls obtained in prior periods, the auditor still should evaluate the design effectiveness and implementation of controls in the current period. The procedures performed as described in the preceding paragraph may help the auditor fulfill this responsibility; however, the auditor may have to supplement these procedures with others. For example, if the controls have not changed from the previous period but the client's business process has, the auditor will need to determine whether the design of controls remains effective in light of the changed business processes.

.40 The auditor may not rely on audit evidence about the operating effectiveness of controls obtained in prior audits for controls that

- have changed significantly since the prior audit,
- pertain to business processes that have changed significantly since the prior audit, and
- mitigate significant risks.

For any control that meets one of the preceding criteria, the auditor should test operating effectiveness in the current audit.

.41 For example, changes in a system that enable an entity to receive a new report from the system probably is not a significant change and, therefore, is unlikely to affect the relevance of prior period audit evidence. On the other hand, a change that causes data to be accumulated or calculated differently probably is significant and, therefore, does affect the relevance of audit evidence obtained in the prior period, in which case the operating effectiveness of the control should be tested in the current period.

Rotating Emphasis on Tests of Controls

.42 When the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test the operating effectiveness of these controls at least once in every third year in an annual audit. There also may be some controls, such as over revenue recognition or inventories that, due to their importance to the client financial statements, might be subject to testing every two years or every year, depending on the risks, even when there are purported to be no changes in controls.

.43 When there are a number of controls for which the auditor plans to use audit evidence obtained in prior audits, the auditor should test the operating effectiveness of *some* controls each audit. However, when the auditor is testing controls for only one or two key classes of transactions in an entity, rotating the testing of these controls may not be warranted.

Determining the Extent of Tests of Controls

.44 The extent of the auditor's tests of controls affects the sufficiency of the audit evidence obtained to support the auditor's assessment of the operating effectiveness of controls. To reduce the extent of substantive procedures in an audit, the tests of controls performed by the auditor need to be sufficient to determine the operating effectiveness of the controls

- at the relevant assertion level and
- either throughout the period, or as of the point in time when the auditor plans to rely on the control.

.45 Factors the auditor may consider in determining the extent of tests of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The relevance and reliability of the audit evidence to be obtained in supporting that the control prevents, or detects and corrects, material misstatements at the relevant assertion level.
- The extent to which audit evidence is obtained from tests of other controls that meet the same audit objective.

- The extent to which the auditor plans to rely on the operating effectiveness of the control in the assessment of risk (and thereby reduce substantive procedures based on the reliance of such control). The more the auditor relies on the operating effectiveness of controls in the assessment of risk, the greater is the extent of the auditor's tests of controls.
- The expected deviation from the control.

Sampling Considerations

.46 The auditor should consider using an audit sampling technique to determine the extent of tests whenever the control is applied on a transaction basis (for example, matching approved purchase orders to supplier invoices) and that it is applied frequently. When a control is applied periodically (for example, monthly reconciliations of accounts receivable subsidiary ledger to the general ledger), the auditor should consider guidance appropriate for testing smaller populations (for example, testing the control application for two months and reviewing evidence the control operated in other months or reviewing other months for unusual items). AU section 350, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1), as amended, and the AICPA Audit Guide *Audit Sampling*, provide further guidance on the application of sampling techniques to determine the extent of testing of controls. The AICPA Audit Guide *Audit Sampling* also provides guidance for testing in smaller populations.

.47 The auditor should consider the expected deviation from the control when determining the extent of tests. As the rate of expected deviation from a control increases, the auditor should increase the extent of testing of the control. However, if the rate of expected deviation is expected to be too high, the auditor may determine that tests of controls for a particular assertion may not be effective. In this case, the auditor may conclude that a control deficiency exists and the auditor should consider its severity and whether it should be communicated to those charged with governance, management, or both.

Extent of Testing IT Controls

.48 Generally, IT processing is inherently consistent. An automated control should function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Therefore, the auditor may be able to limit the testing of an IT application control to one or a few instances of the control operation, provided that the auditor determines that related IT general controls operated effectively during the period of reliance.

Assessing the Operating Effectiveness of Controls

Evidence About Operating Effectiveness

.49 The concept of effectiveness of the operation of controls recognizes that some deviations in the way a client applies the controls may occur. Deviations from prescribed controls may be caused by factors such as changes in key personnel, significant seasonal fluctuations in volume of transactions, and human error.

.50 When the auditor encounters deviations in the operation of controls, those deviations will have an effect on the auditor's assessment of operating effectiveness. A control with an observed non-negligible deviation rate is not an effective control. For example, if a test is designed in which the auditor selects a sample of, say, 25 items and expects no deviations, the finding of one deviation would be considered a non-negligible deviation because, based on the results of the test of the sample, the desired level of confidence has not been obtained.

.51 There are sources of audit evidence beyond the auditor's tests of controls that contribute to the auditor's assessment of the operating effectiveness of controls. The extent of misstatements detected by performing substantive procedures also may alter the auditor's judgment about the effectiveness of controls in a negative direction. However, misstatement-free results of substantive tests do not indicate that a lower assessment of control risk may be substituted for the one supported by the procedures the auditor used to assess control risk.

Investigating Additional Implications of Identified Deviations

.52 When the auditor detects control deviations during the performance of tests of controls, the auditor should make specific inquiries to understand these matters and their potential consequences, for example, by inquiring about the timing of personnel changes in key internal control functions.

.53 Deviations in the application of control activities may be caused by the ineffective operation of indirect controls such as IT general controls, the control environment, or other components of internal control. To gain an understanding of the deviations in control, the auditor may wish to make inquires and perform other tests to identify possible weaknesses in the control environment or other indirect controls.

.54 For example, suppose that one of the client's primary controls related to the existence of inventory—periodic test counts—had several instances where the number of items counted by the count teams did not agree to the actual physical count of the items on hand. When gaining a further understanding of the nature of these deviations, the auditor determines that the underlying cause is poor training of the test count teams and a lack of written instructions. Training and written instructions are indirect controls that may affect the operating effectiveness of controls other than those related to existence. For example, the lack of training and instruction could result in the count teams reporting the wrong product number or description, which also could affect the valuation of inventory. This finding could cause the company and auditor to conclude that a recount is necessary once the teams are properly trained.

Assessing Effectiveness

.55 After considering the results of tests of controls and any misstatements detected from the performance of substantive procedures, the auditor should determine whether the audit evidence obtained provides an appropriate basis for reliance on the controls. If the reliance on the controls is not warranted, the auditor should determine whether

- additional tests of controls are necessary or
- if the potential risks of misstatement will be addressed using substantive procedures.

Once the auditor has concluded that reliance on certain controls is not warranted, it is unnecessary to perform further tests of those controls.

Deficiencies in the Operation of Controls

.56 The auditor may consider whether deviations in the operation of controls have been caused by an underlying control deficiency. When evaluating the reason for a control deviation, the auditor may consider the following:

- Whether the control is automated (in the presence of effective information technology general controls, an automated application control is expected to perform as designed)
- The degree of intervention by entity personnel contributing to the deviation (for example, was the deviation evidence of a possible override)
- Management's actions in response to the matter (if management was aware of the deviation)

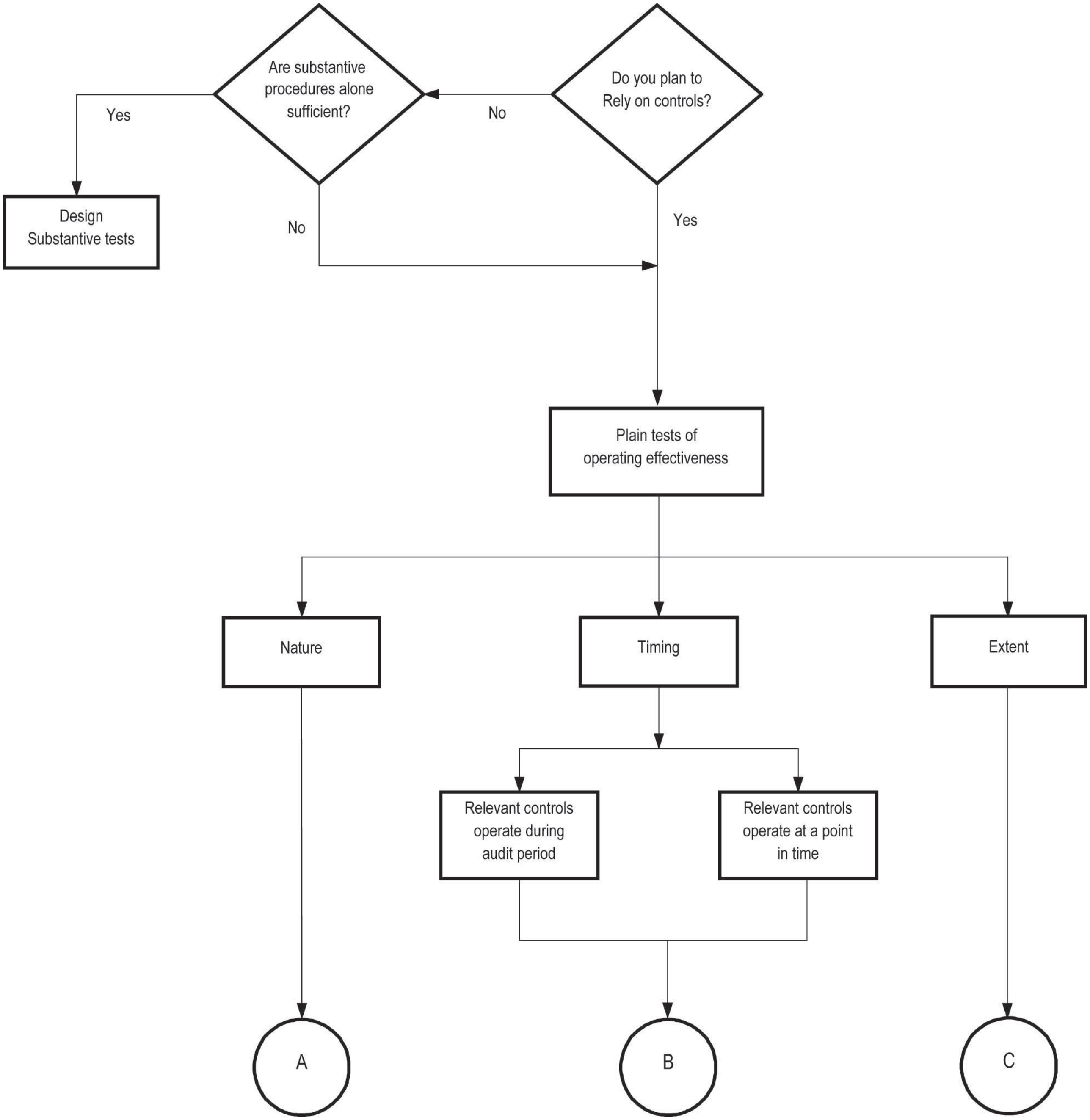
.57 Regardless of the reason for the deviation, numerous or repeated instances of the deviation may constitute a significant deficiency or material weakness. The following are examples of circumstances that may be control deficiencies of some magnitude:

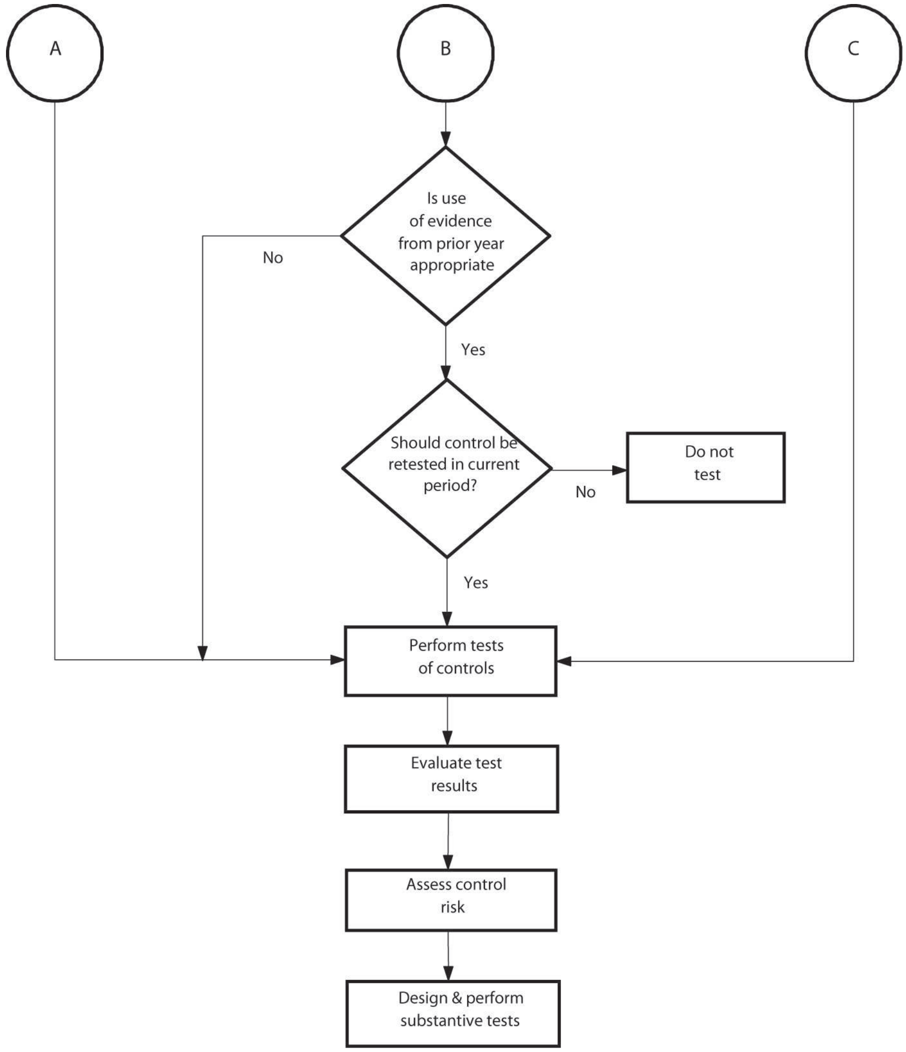
- Failure in the operation of properly designed controls within a significant account or process, for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy (for example,

the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements).

- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. For example, a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. However, a preventive control failure may be mitigated by an effective detective control that prevents the misstatement of the financial statements. Suppose the inventory security control fails. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement to the financial statements if performed effectively and timely (near or at the reporting date). In the absence of a timely count, a deficient preventive control may be a deficiency in internal controls of some magnitude.
- Failure to perform reconciliations of significant accounts, for example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, consistent under accruals of expenses or overstatement of allowances at the direction of management.
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls that would enable the entity to prepare financial statements in accordance with generally accepted accounting principles.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.

.58 The following diagram summarizes the auditor's considerations related to tests of controls.


Are substantive procedures alone sufficient?
Do you plan to Rely on controls?
No
Yes
Design Substantive tests
No
Yes
Plain tests of operating effectiveness
Nature
Timing
Extent
Relevant controls operate during audit period
Relevant controls operate at a point in time
A
B
C



Documentation

.59 In regards to the performance of further audit procedures, the auditor should document the following:

- The overall responses to address the assessed risks of misstatement at the financial statement level
- The nature, timing, and extent of the further audit procedures
- The linkage of those procedures with the assessed risks at the relevant assertion level
- The results of the audit procedures
- The conclusions reached with regard to the use in the current audit of audit evidence about the operating effectiveness of controls that was obtained in a prior audit

The manner in which these matters are documented is based on the auditor's professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

[*The next page is 5301.*]

AAM Section 5300

Performing Substantive Procedures

.01 The objective of substantive procedures is to detect individual misstatements that alone or in the aggregate cause material misstatements at the assertion level. Substantive procedures include the following:

- Tests of details of transactions, account balances, and disclosures.
- Analytical procedures. AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), provides guidance on the application of analytical procedures as substantive tests.

.02 The auditor should plan and perform substantive procedures to be responsive to the related assessed risks of material misstatement. However, the auditor should perform certain tests regardless of the risk assessment because the risk assessment may not identify all risks.

- *Substantive tests of material items*. The auditor should perform substantive procedures for all relevant assertions for each material class of transactions, account balance, and disclosure. For example, if the auditor determines that long term debt is a material account, the auditor should perform substantive tests for all assertions that are relevant to long term debt, even if the auditor has determined that it is unlikely that the assertion could contain a material misstatement. The auditor may determine that the risk of the entity not having the obligation to repay the debt (the obligation assertion) is low, but nevertheless, the auditor should perform a substantive procedure (for example, confirming the terms of the debt with the lender) to address the risk. Because the account is material, the auditor is precluded from relying solely on risk assessment procedures or tests of controls to support the conclusion.
- *Substantive tests related to the financial statement reporting system*. On all engagements the auditor should
  - — agree the financial statements, including their accompanying notes, to the underlying accounting records and
  - — examine material journal entries and other adjustments made during the course of preparing the financial statements. The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the client's financial reporting system and the associated risks of material misstatement.

.03 When, in accordance with paragraph .110 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. When the audit approach to significant risks consists only of substantive procedures, the audit procedures appropriate to address such significant risks consist of

- tests of details only
- a combination of tests of details and analytical procedures

That is, to address significant risks, it is unlikely that audit evidence obtained solely from substantive analytical procedures will be sufficient.

Nature of Substantive Procedures

.04 Substantive procedures include tests of details and substantive analytical procedures. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Tests of details are ordinarily more appropriate to obtain audit evidence regarding certain relevant assertions about account balances, including existence and valuation.

.05 The auditor should plan substantive procedures to be responsive to the planned level of detection risk. In some situations, the auditor may determine that performing only substantive analytical procedures may be sufficient to reduce the planned level of detection risk to an acceptably low level. For example, the auditor may determine that performing only substantive analytical procedures is responsive to the planned level of detection risk for an individual class of transactions where the auditor's assessment of risk has been reduced by obtaining audit evidence from performance of tests of the operating effectiveness of controls. In other situations, the auditor may determine that tests of details only are appropriate, or that a combination of substantive analytical procedures and tests of details is most responsive to the assessed risks. The auditor's determination as to the substantive procedures that are most responsive to the planned level of detection risk is affected by whether the auditor has obtained audit evidence about the operating effectiveness of controls.

Tests of Details

.06 The auditor should design tests of details responsive to the assessed risk with the objective of obtaining sufficient appropriate audit evidence to achieve the planned level of assurance at the relevant assertion level. In designing substantive procedures related to the existence or occurrence assertion, the auditor should select from items contained in a financial statement amount and should obtain the relevant audit evidence. On the other hand, in designing audit procedures related to the completeness assertion, the auditor should select from audit evidence indicating that an item should be included in the relevant financial statement amount and should investigate whether that item is so included. The knowledge gained when understanding the business and its environment should be helpful in selecting the nature, timing, and extent of audit procedures related to the completeness assertion. For example, the auditor might inspect subsequent cash disbursements and compare them with the recorded accounts payable to determine whether any purchases had been omitted from accounts payable.

Substantive Analytical Procedures

.07 In designing substantive analytical procedures, the auditor should consider such matters as the following:

- The suitability of using substantive analytical procedures, given the assertions. Analytical procedures may not be suitable for all assertions. For example, transactions subject to management discretion (such as a decision to delay advertising expenses) may lack the predictability between periods or financial statement accounts that is necessary to perform and effective analytical procedure.
- The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed. To assess the reliability of the data used in a substantive analytical procedure, the auditor may consider its source and the conditions under which it was gathered.
- Whether the expectation is sufficiently precise to identify the possibility of a material misstatement at the desired level of assurance. The precision of the auditor 's expectation depends on (among other things):
  - — The identification and consideration of factors that significantly affect the amount being audited (for example, contributions to an employee 401(k) plan depends on compensation expense and the percentage of the employer contribution committed to by management).
  - — The level of data used to develop the expectation. Typically, expectations developed at a detailed level have a greater chance of detecting a material misstatement than do broad comparisons.
- The amount of any difference in recorded amounts from expected values that is acceptable. The smaller the difference between the expected amount and the recorded amount that can be accepted, the more precise the expectation will typically be.

- The risk of management override of controls. Management override of controls might result in adjustments to the financial statements outside of the normal financial reporting process, which may result in artificial changes to the financial statement relationships being analyzed. These artificial relationships may result in the auditor drawing erroneous conclusions about the substantive analytical procedures.

Paragraphs .57–.67 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), direct the auditor to perform certain procedures to assess the risk of management override of controls.

.08 Paragraphs .09–.21 of AU section 329 provide additional guidance on the design of substantive analytical procedures.

Timing of Substantive Procedures

Substantive Procedures Performed at an Interim Date

.09 In some circumstances, the auditor may choose to perform substantive procedures at an interim date. When the auditor performs procedures as of a date in advance of year end, the risk that the auditor will fail to detect a material misstatement that may exist at year end is increased. This risk increases as the length of the period between interim tests and year end increases. The following table summarizes factors that may be considered when determining whether to perform substantive procedures at an interim date.

Matters to Consider in Determining Whether to Perform Substantive Procedures at an Interim Date

	Likelihood of Performing Substantive Procedures at an Interim Date	
Factor to consider	*More likely*	*Less likely*
Control environment and other relevant controls	Effectively designed or operating controls, including the control environment	Ineffectively designed or operating controls, including the control environment
The availability of information for the remaining period	Information is available that will allow the auditor to perform procedures related to the remaining period	Lack of information necessary to perform procedures related to the remaining period
Assessed risk	Lower risk of material misstatement for the relevant assertion	Higher risk of material misstatement for the relevant assertion
Nature of transactions or account balances and relevant assertions	Year-end balances are reasonably predictable with respect to amount, relative significance, and composition	Year-end balances can fluctuate significantly from interim balances, for example, due to rapidly changing business conditions, seasonality of business, or transactions that are subject to management's discretion
Ability to perform audit procedures to cover remaining period	The auditor will be able to perform all necessary procedures to cover the remaining period	The auditor's ability to perform procedures relating to the remaining period is limited, for example, by a lack of available information

.10 The objective of some of the tests may make the results of the tests irrelevant if performed at an interim date. For example, tests related to the preparation of the financial statements or the client's compliance with debt covenants typically provide relevant audit evidence only if performed at the period end.

.11 In addition to those items described in the preceding table, the circumstances of the engagement may result in the performance of certain tests at an interim date. For example, a client may request that the auditor identify all material misstatements a short period of time after year end (which is common for companies that wish to issue a press release of their earnings for the period). In that situation, the auditor may decide to confirm receivables prior to year end because the time period between the end of the period and the release of earnings is too short to allow the auditor to send and receive confirmations of customers and to complete the test work.

.12 The auditor's ability to perform audit procedures relating to the remaining period depends a great deal on whether the client's accounting system is able to provide the information needed for the auditor to perform his or her procedures. The auditor should consider whether that information is sufficient to permit investigation of the following:

- Significant unusual transactions or entries (including those at or near the period end)
- Other causes of significant fluctuations or fluctuations that did not occur
- Changes in the composition of the classes of transactions or account balances

.13 The timing of audit procedures also involves consideration of whether related audit procedures are coordinated properly. This consideration includes, for example, the following:

- Coordinating the audit procedures applied to related party transactions and balances.
- Coordinating the testing of interrelated accounts and accounting cutoffs.
- Maintaining temporary audit control over assets that are readily negotiable and simultaneously testing such assets and cash on hand and in banks, bank loans, and other related items.

.14 When performing substantive procedures at an interim date, the auditor should perform substantive procedures or substantive procedures combined with tests of controls to cover the remaining period that provide a reasonable basis for extending audit conclusions from the interim date to the period end.

.15 When performing substantive procedures at an interim date, the auditor may reconcile the account balance at the interim date to the balance in the same account at year end. The reconciliation will allow the auditor to

- identify amounts that appear unusual,
- investigate these amounts, and
- define the appropriate population to perform substantive analytical procedures or tests of details to test the remaining period.

.16 If misstatements are detected in classes of transactions or account balances at an interim date, the auditor should consider modifying the related assessment of risk and the planned nature, timing, or extent of the substantive procedures covering the remaining period that relate to such classes of transactions or account balances, or the auditor may extend or may repeat such audit procedures at the period end.

Substantive Procedures Performed in Previous Audits

.17 In most cases, audit evidence from substantive procedures performed in a prior audit provides little or no audit evidence for the current period. To use audit evidence obtained during a prior period in the current period audit, both the audit evidence and the related subject matter must not fundamentally change. For example, a legal opinion would continue to be relevant audit evidence if it were received in a prior period related to the structure of a securitization transaction and no changes have occurred during the current period. If the auditor plans to use audit evidence from a prior period in the current audit, the auditor should perform audit procedures during the current period to establish the continuing relevance of the audit evidence.

Extent of the Performance of Substantive Procedures

.18 The greater the risk of material misstatement, the greater the extent of the auditor's substantive procedures. However, the nature of the audit procedures is of most importance in responding to assessed risks. Increasing the extent of an audit procedure is appropriate only if the procedure itself is relevant to the specified risk.

.19 Considerations for Designing Tests of Details. When determining the extent of the tests of details, the auditor ordinarily thinks in terms of sample size. However, the auditor also may consider other matters, including whether it is more effective to use other selective means of testing, such as selecting large or unusual items from a population, rather than performing sampling or stratifying the population into homogeneous subpopulations for sampling. AU section 350, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1), and the AICPA Audit Guide *Audit Sampling*, provide guidance on the use of sampling and other means of selecting items for testing.

Adequacy of Presentation and Disclosure

.20 The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, are in accordance with generally accepted accounting principles (GAAP). The auditor should consider whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information. The presentation of financial statements in conformity with GAAP also includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their related notes, including, for example, the terminology used, the amount of detail given, the classification of items in the financial statements, and the bases of amounts set forth. The auditor should consider whether management should have disclosed a particular matter in light of the circumstances and facts of which the auditor is aware at the time. In performing the evaluation of the overall presentation of the financial statements, including the related disclosures, the auditor should consider the assessed risk of material misstatement at the relevant assertion level. See paragraph .15 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), for a description of the relevant assertions related to presentation and disclosure.

Documentation

.21 In regards to the performance of further audit procedures, the auditor should document the following:

- The overall responses to address the assessed risks of misstatement at the financial statement level
- The nature, timing, and extent of the further audit procedures
- The linkage of those procedures with the assessed risks at the relevant assertion level
- The results of the audit procedures
- The conclusions reached with regard to the use in the current audit of audit evidence about the operating effectiveness of controls that was obtained in a prior audit

The manner in which these matters are documented is based on the auditor's professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

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AAM Section 5400

Audit Sampling Considerations

.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), the next decision to be made is to determine how many items to apply which procedures to—that is, the extent of testing. The greater the risk of material misstatement, the less detection risk that can be accepted, and, consequently, the greater the extent of substantive procedures. Because the risks of material misstatement include consideration of the effectiveness of internal control, the extent of substantive procedures may be reduced by satisfactory results from tests of the operating effectiveness of controls. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

.02 In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size, which is affected by the planned level of detection risk, tolerable misstatement, expected misstatement, and nature of the population. However, the auditor should also consider other matters, including whether it is more effective to use other selective means of testing, such as selecting large or unusual items from a population as opposed to performing sampling or stratifying the population into homogeneous subpopulations for sampling.

Authoritative Standards

.03 AU section 350, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1), addresses a variety of issues relating to the auditor's use of sampling in an audit engagement. However, AU section 350 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 AU section 350.

When AU section 350 Applies

.04 Audit sampling is only one of many tools used by auditors to obtain sufficient, appropriate audit evidence to support an opinion on financial statements. AU section 350 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

- in tests of controls in internal control to evaluate operating effectiveness from prescribed controls,
- in substantive tests of details of account balances and classes of transactions, and
- in dual purpose tests that assess control risk and test whether the monetary amount of a transaction is correct.

.05 The portion of AU section 350 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.

.06 According to AU section 350, 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. AU section 350 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 could be 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.

.07 In determining whether AU section 350 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 AU section 350 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 AU section 350 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 assess the accuracy and valuation of the remaining invoices, the auditor is not sampling according to AU section 350—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 results of the test of large sales invoices, inquiry and observations, analytical procedures, and other auditing procedures performed on the smaller items related to overstatement of sales. However, in practice, it is difficult to attain high assurance regarding a significant aggregate amount of smaller items in the population from procedures other than sampling, such as analytical tests.

.08 The way in which the population is defined can determine whether the requirements of AU section 350 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 AU section 350 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 AU Section 350

.09 AU section 350 contains the following provisions regarding sampling in connection with substantive testing:

- 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 (see paragraph .21 of AU section 350). 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.
- 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 (see paragraph .22 of AU section 350). 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.
- A requirement that the auditor considers tolerable misstatement in planning audit sampling applications in the examination of account balances and classes of transactions (see paragraph .18 of AU section 350). 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. AU section 350 asks the auditor to consider tolerable misstatement and to recognize that it is one of the factors influencing sample size.
- A requirement that the auditor selects a sample that can be expected to be representative of the population (see paragraph .24 of AU section 350). 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, but that he or she should use a method that avoids bias (for example, selecting only simple transactions for testing).

- A requirement that the auditor considers selected sample items to which the auditor is unable to apply planned audit procedures to determine their effect on the evaluation of the sample (see paragraph .25 of AU section 350). For example, sometimes the auditor may not be able to apply planned audit procedures to selected sample items because the entity may not be able to locate supporting documentation. 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 audit procedures that would provide sufficient appropriate audit evidence to form a conclusion.
- A requirement that the auditor projects the misstatement results of the sample to the items from which the sample was selected (see paragraph .26 of AU section 350). Because 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 requirement asks the auditor to measure the likely misstatement in the population from which the sample was drawn and to consider it in reaching his or her conclusions.
- A requirement that the auditor considers, 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 (see paragraph .30 of AU section 350).

Documentation Requirements

.10 AU section 350 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. AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), states that the auditor "must develop an audit plan in which the auditor documents the audit procedures," and AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), 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); and
- 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 may document for tests of controls are discussed in paragraph .25 of this section. Examples of items that the auditor typically documents for substantive tests are discussed in paragraph .55.

Determining Extent of Testing in a Small Business[1] Without Sampling

.11 Small businesses have certain characteristics that may influence the auditor's decision to use audit sampling.

.12 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 necessary when the necessary audit assurance is attained by examining a significant portion or aggregate value of all the transactions.

.13 Paragraph .01 of AU section 350 defines *audit sampling* as "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 AU section 350, may provide a more effective and efficient audit approach for a small business engagement.

.14 These alternative approaches include the following:

- Procedures applied to 100 percent of a certain group (strata) of transactions or balances
- Testing unusual items without applying procedures to the remainder of the population
- 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

.15 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.

.16 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

.17 The auditor is required to 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 the size of the item, whether the item is unusual, prior experience with the client, and whether the item involves a related party.

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

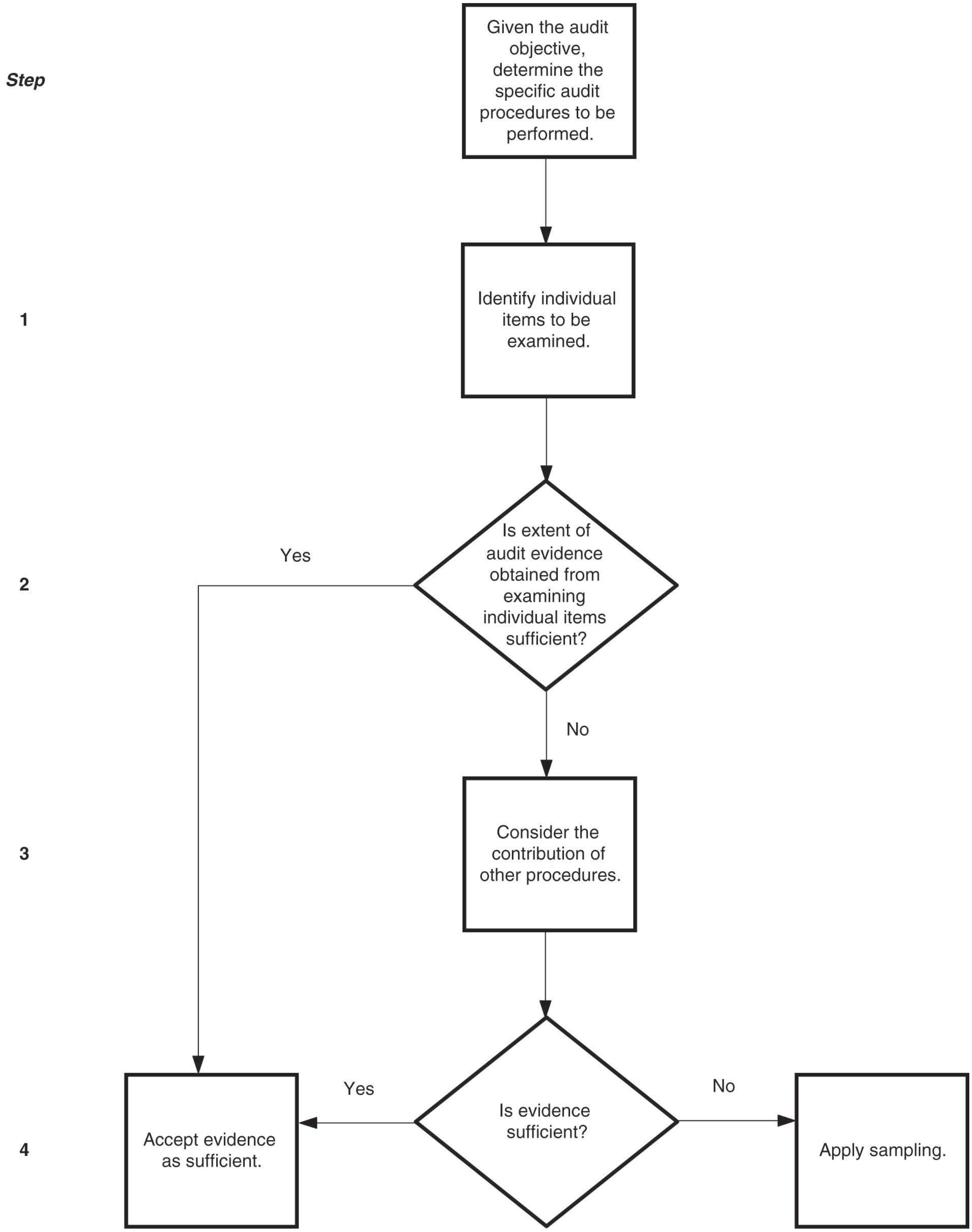
Number of Accounts	*Balances*	*Total Accounts*
4	$100,000 or more	$625,000
7	$25,000-99,999	375,000
62	$1-24,999	300,000
73		$1,300,000

In this case, if the eleven largest accounts are confirmed by the auditor, most of the accounts receivable balance is supported ($1,000,000 out of $1,300,000, or 77 percent). Provided the remaining $300,000 is not greater than tolerable misstatement or can be tested through other audit procedures, it may not be necessary to design a sample of the remaining items. 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).

[1] The concepts discussed in this section can also be applied to certain less complex account balances and classes of transactions in more complex entities.

Flowchart 1

An Audit Sampling Approach for a Small Business



Is Extent of Audit Evidence Obtained Sufficient?

.19 The following are some factors in evaluating the sufficiency of audit evidence obtained in tests of details for a particular account balance or class of transactions:

- 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.
- 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.
- Possible relationship of the misstatement to other phases of the audit. If it is determined that the misstatement is due to fraud, this would ordinarily require a broader consideration of the possible implications than would the discovery of an error.
- 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.

Consider Contribution of Other Procedures

.20 The auditor may 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 audit evidence 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 may 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 four 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 individually or in combination with other untested amounts be material to the financial statements. If the remaining population is less than material, the auditor may decide that no additional sampling is necessary, but may consider whether other procedures can provide sufficient assurance that any misstatement of the remaining population is not significant. 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 audit evidence obtained by testing individual items along with the contribution of other procedures). The final factor is the qualitative aspects of the misstatement. These include (*a*) the nature and cause of misstatements, such as whether there are differences in principle or in application, are errors or are caused by fraud, or are due to misunderstanding of instructions or to carelessness, and (*b*) the possible relationship of the misstatements to other phases of the audit. The discovery of fraud ordinarily requires a broader consideration of possible implications than does the discovery of an error.

Audit Sampling for Tests of Controls

.25 AU section 350 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:

- *Determine the objective of the test*. The objective of tests of controls is to provide evidence about the operating effectiveness 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. As with any test, it should be related to a relevant assertion.
- *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 (for example, the initials of the approving individual), a deviation condition would be an invoice that is not initialed by the appropriate individual. 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.'"
- *Define the population*. The population selected should 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.
- *Defining the period covered by the test*. For samples to be representative of the period under audit, the population generally includes 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 audit evidence about design or operation of controls or substantive correctness of the balances or transactions in the interim period 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.

- *Defining the sampling unit*. The sampling unit is defined in light of the control being tested. A sampling unit may be, for example, a document, an entry, or a line item, where examination of the sampling unit provides evidence of the operation of the control. An important efficiency consideration in selecting a sampling unit is the manner in which documents are filed and cross-referenced.
- *Determine the method of selecting the sample*. Any sample that is selected should be representative of the population (selected in an unbiased manner) and all items should have an opportunity to be selected. Random number selection is generally 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 paragraph .60 of this section.
- *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 paragraph .28 of this section. A description of statistical sampling begins with paragraph .31 of this section.
- *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, 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.
- *Evaluate the sample results*. Guidance for evaluating nonstatistical sampling results begins with paragraph .30 of this section and guidance for evaluating statistical sampling results begins with paragraph .32 of this section.
- *Document the sampling procedure*. Examples of items that the auditor typically documents for tests of controls include the following:
  - A description of the control being tested. The control objectives related to the sampling application, including the relevant assertions
  - 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 acceptable risk of overreliance on controls (or desired confidence or assurance level), the tolerable deviation rate, and the expected population deviation rate used in the application[2]
- — The method of sample-size determination
- — The method of sample selection
- — The selected sample items
- — A description of how the sampling procedure was performed
- — The evaluation of the sample and 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 (percentage) 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:

Factor	*General Effect on Sample Size*
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 paragraph .26 of this section in determining sample sizes.

.29 Paragraph .23 of AU section 350 states that to determine the number of items to be selected in a sample for a particular test of details, the auditor should consider the tolerable misstatement and the expected misstatement, the audit risk, the characteristics of the population, the assessed risk of material misstatement (inherent risk and control risk), and the assessed risk for other substantive procedures related to the same assertion. An auditor who applies statistical sampling uses tables or formulas to compute sample size based on these judgments. An auditor who applies nonstatistical sampling uses professional judgment

[2] In some instances, sample size inputs such as acceptable risk of overreliance, tolerable deviation rate, and expected deviation rate are built into firm-wide sample size tables. In these instances, reference to firm sample size guidance is sufficient (that is, each team does not need to document inputs that are implicit in the firm's sample size tables).

to relate these factors in determining the appropriate sample size. Ordinarily, this would result in a sample size comparable to the sample size resulting from an efficient and effectively designed statistical sample, considering the same sampling parameters.[3] It is important to note, however, that auditors are not required to specifically compute a statistical sample size. Nevertheless, auditors might find it helpful to be familiar with the tables in paragraphs .33–.36 of this section. 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.

.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, consideration may be given to 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:

a. *Decide on the attributes to test*. The tests of controls may include the testing of one or more attributes. Proper evaluation of the results may require testing and evaluating each attribute separately.

b. *Define the population from which the sample items should be selected*. The auditor should make sure that the population is appropriate for the audit objective as described in paragraph .25 of this section.

c. 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. When auditors seek high assurance from important controls, the risk is often set at 10 percent or less.
- *Tolerable rate*. Higher assessments of control risk will permit higher tolerable deviation rates. When auditors seek high assurance from important controls, the tolerable deviation rates are generally set at 10 percent or less.
- *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 may 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.

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[3] This guidance does not suggest that the auditor using nonstatistical sampling compute a corresponding sample size using statistical theory.

d. *Determine the appropriate sample size*. Example sample sizes are found in the tables in paragraphs .33–.34 of this section. The table in paragraph .33 is designed for a risk of assessing control risk too low of 5 percent, and the table in paragraph .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 paragraph .60 of this section 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 paragraphs .35–.36 of this section 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.* AU section 350 and the AICPA Audit Guide *Audit Sampling* do not require specific documentation of audit sampling applications. See paragraph .10 of this section for certain documentation requirements of AU section 339. Examples of items that the auditor typically documents for tests of controls are discussed in paragraph .25 of this section. Auditors may also refer to the Audit Guide *Audit Sampling* for more information.

.33

Statistical Sample Sizes for Test of Controls—5 Percent Risk of Overreliance (With Number of Expected Errors in Parentheses)

Expected Deviation Rate	Tolerable Deviation 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)
0.25%	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
0.50%	313(2)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
0.75%	386(3)	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00%	590(6)	257(3)	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25%	1,030(13)	303(4)	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50%		392(6)	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75%		562(10)	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00%		846(17)	294(6)	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25%		1,466(33)	390(9)	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50%			513(13)	234(6)	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75%			722(20)	286(8)	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00%			1,098(33)	361(11)	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25%			1,936(63)	458(15)	238(8)	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50%				624(22)	280(10)	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75%				877(33)	341(13)	185(7)	129(5)	100(4)	76(3)	40(2)	22(1)
4.00%				1,348(54)	421(17)	221(9)	146(6)	100(4)	89(4)	40(2)	22(1)
5.00%					1,580(79)	478(24)	240(12)	158(8)	116(6)	40(2)	30(2)
6.00%						1,832(110)	532(32)	266(16)	179(11)	50(3)	30(2)
7.00%								585(41)	298(21)	68(5)	37(3)
8.00%									649(52)	85(7)	37(3)
9.00%										110(10)	44(4)
10.00%										150(15)	50(5)
12.50%										576(72)	88(11)
15.00%											193(29)
17.50%											720(126)

Note: Sample sizes over 2,000 items not shown. This table assumes a large population.

.34

Statistical Sample Sizes for Test of Controls—10 Percent Risk of Overreliance (With Number of Expected Errors in Parentheses)

Tolerable Deviation Rate

Expected Deviation 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)
0.25%	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
0.50%	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
0.75%	265(2)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.00%	398(4)	176(2)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.25%	708(9)	221(3)	132(2)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.50%	1,463(22)	265(4)	132(2)	105(2)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.75%		390(7)	166(3)	105(2)	88(2)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
2.00%		590(12)	198(4)	132(3)	88(2)	75(2)	48(1)	42(1)	38(1)	25(1)	18(1)
2.25%		974(22)	262(6)	132(3)	88(2)	75(2)	65(2)	42(1)	38(1)	25(1)	18(1)
2.50%			353(9)	158(4)	110(3)	75(2)	65(2)	58(2)	38(1)	25(1)	18(1)
2.75%			471(13)	209(6)	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.00%			730(22)	258(8)	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.25%			1,258(41)	306(10)	153(5)	113(4)	82(3)	58(2)	52(2)	25(1)	18(1)
3.50%				400(14)	194(7)	113(4)	82(3)	73(3)	52(2)	25(1)	18(1)
3.75%				583(22)	235(9)	131(5)	98(4)	73(3)	52(2)	25(1)	18(1)
4.00%				873(35)	274(11)	149(6)	98(4)	73(3)	65(3)	25(1)	18(1)
5.00%					1,019(51)	318(16)	160(8)	115(6)	78(4)	34(2)	18(1)
6.00%						1,150(69)	349(21)	182(11)	116(7)	43(3)	25(2)
7.00%							1,300(91)	385(27)	199(14)	52(4)	25(2)
8.00%								1,437(115)	424 34)	60(5)	25(2)
9.00%									1,577(142)	77(7)	32(3)
10.00%										100(10)	38(4)
12.50%										368(46)	63(8)
15.00%											126(19)
17.50%											457(80)

Note: Sample sizes over 2,000 items not shown. This table assumes a large population.

.35

Statistical Sampling Results Evaluation Table for Tests of Controls— Upper Limits at 5 Percent Risk of Overreliance

	Actual Number of Deviations Found										
Sample Size	**0**	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
20	14.0	21.7	28.3	34.4	40.2	45.6	50.8	55.9	60.7	65.4	69.9
25	11.3	17.7	23.2	28.2	33.0	37.6	42.0	46.3	50.4	54.4	58.4
30	9.6	14.9	19.6	23.9	28.0	31.9	35.8	39.4	43.0	46.6	50.0
35	8.3	12.9	17.0	20.7	24.3	27.8	31.1	34.4	37.5	40.6	43.7
40	7.3	11.4	15.0	18.3	21.5	24.6	27.5	30.4	33.3	36.0	38.8
45	6.5	10.2	13.4	16.4	19.2	22.0	24.7	27.3	29.8	32.4	34.8
50	5.9	9.2	12.1	14.8	17.4	19.9	22.4	24.7	27.1	29.4	31.6
55	5.4	8.4	11.1	13.5	15.9	18.2	20.5	22.6	24.8	26.9	28.9
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	20.8	22.8	24.8	26.7
65	4.6	7.1	9.4	11.5	13.6	15.5	17.5	19.3	21.2	23.0	24.7
70	4.2	6.6	8.8	10.8	12.7	14.5	16.3	18.0	19.7	21.4	23.1
75	4.0	6.2	8.2	10.1	11.8	13.6	15.2	16.9	18.5	20.1	21.6
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	20.3
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.9	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
300	1.0	1.6	2.1	2.6	3.1	3.5	4.0	4.4	4.8	5.2	5.6
400	0.8	1.2	1.6	2.0	2.3	2.7	3.0	3.3	3.6	3.9	4.3
500	0.6	1.0	1.3	1.6	1.9	2.1	2.4	2.7	2.9	3.2	3.4

Note: This table presents upper limits (body of table) as percentages. This table assumes a large population.

.36

Statistical Sampling Results Evaluation Table for Tests of Controls—Upper Limits at 10 Percent Risk of Overreliance

Sample Size	Actual Number of Deviations Found 0	1	2	3	4	5	6	7	8	9	10
20	10.9	18.1	24.5	30.5	36.1	41.5	46.8	51.9	56.8	61.6	66.2
25	8.8	14.7	20.0	24.9	29.5	34.0	38.4	42.6	46.8	50.8	54.8
30	7.4	12.4	16.8	21.0	24.9	28.8	32.5	36.2	39.7	43.2	46.7
35	6.4	10.7	14.5	18.2	21.6	24.9	28.2	31.4	34.5	37.6	40.6
40	5.6	9.4	12.8	16.0	19.0	22.0	24.9	27.7	30.5	33.2	35.9
45	5.0	8.4	11.4	14.3	17.0	19.7	22.3	24.8	27.3	29.8	32.2
50	4.6	7.6	10.3	12.9	15.4	17.8	20.2	22.5	24.7	27.0	29.2
55	4.2	6.9	9.4	11.8	14.1	16.3	18.4	20.5	22.6	24.6	26.7
60	3.8	6.4	8.7	10.8	12.9	15.0	16.9	18.9	20.8	22.7	24.6
65	3.5	5.9	8.0	10.0	12.0	13.9	15.7	17.5	19.3	21.0	22.8
70	3.3	5.5	7.5	9.3	11.1	12.9	14.6	16.3	18.0	19.6	21.2
75	3.1	5.1	7.0	8.7	10.4	12.1	13.7	15.2	16.8	18.3	19.8
80	2.9	4.8	6.6	8.2	9.8	11.3	12.8	14.3	15.8	17.2	18.7
90	2.6	4.3	5.9	7.3	8.7	10.1	11.5	12.8	14.1	15.4	16.7
100	2.3	3.9	5.3	6.6	7.9	9.1	10.3	11.5	12.7	13.9	15.0
125	1.9	3.1	4.3	5.3	6.3	7.3	8.3	9.3	10.2	11.2	12.1
150	1.6	2.6	3.6	4.4	5.3	6.1	7.0	7.8	8.6	9.4	10.1
200	1.2	2.0	2.7	3.4	4.0	4.6	5.3	5.9	6.5	7.1	7.6
300	0.8	1.3	1.8	2.3	2.7	3.1	3.5	3.9	4.3	4.7	5.1
400	0.6	1.0	1.4	1.7	2.0	2.4	2.7	3.0	3.3	3.6	3.9
500	0.5	0.8	1.1	1.4	1.6	1.9	2.1	2.4	2.6	2.9	3.1

Note: This table presents upper limits (body of table) 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 the risks of material misstatement and relies on a combination of further control tests, 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 and relevant assertion. 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 (*a*) apply other auditing procedures (for example, analytical procedures) to items that do not exceed a given amount or possess an unusual characteristic or (*b*) 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 may 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 (*a*) test the reasonableness of one or more assertions about a financial statement amount (for example, the existence of accounts receivable) or (*b*) 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 monetary unit 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 from unstratified populations with high variation are generally much larger than stratified samples from the same population.

.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. This risk is generally controlled by setting an adequate or conservative estimate of expected misstatement and increasing the sample size accordingly.

.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 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 do the following:

- 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.
- Propose known misstatements to management for correction, unless the amounts are trivial.
- Compare the tolerable misstatement for the account balance or class of transactions with the total projected misstatement, adjusted for any 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. In accordance with paragraph .30 of AU section 350, projected misstatement results for all audit sampling applications and all known misstatements from nonsampling applications should be considered in the aggregate along with other relevant audit evidence when the auditor evaluates whether the financial statements taken as a whole may be 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*. AU section 350 and the AICPA Audit Guide *Audit Sampling* do not require specific documentation of audit sampling applications. See paragraph .10 of this section for certain documentation requirements of AU section 339. Examples of items that the auditor may document for substantive tests include the following:

- The objectives of the test the accounts and assertions affected
- The definition of the population and the sampling unit, including how the auditor determined the completeness of the population
- The definition of a misstatement
- The risk of incorrect acceptance or level of desired assurance (confidence)
- The risk of incorrect rejection, if used
- Estimated and tolerable misstatement
- The audit sampling technique used
- The method of sample selection
- Identification of the items selected
- A description of the performance of the sampling procedures and a list of misstatements identified in the sample
- The evaluation of the sample (for example, projection and consideration of sampling risk)
- A summary of the overall conclusion (if not evident from the results)
- Any qualitative factors considered significant in making the sampling assessments and judgments

.56 ***Nonstatistical Sampling for Substantive Tests of Details***. Neither paragraph .23 of AU section 350 states that to determine the number of items to be selected in a sample for a particular test of details, the auditor should consider the tolerable misstatement and the expected misstatement, the audit risk, the characteristics of the population, the assessed risk of material misstatement (inherent risk and control risk), and the assessed risk for other substantive procedures related to the same assertion. An auditor who applies statistical sampling uses tables or formulas to compute sample size based on these judgments. An auditor who applies nonstatistical sampling uses professional judgment to relate these factors in determining the appropriate sample size. Ordinarily, this would result in a sample size comparable to the sample size resulting from an efficient and effectively designed statistical sample, considering the same sampling parameters.[4] It is important to note, however, that auditors are not required to specifically compute a statistical sample size. Nevertheless, 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

[4] This guidance does not suggest that the auditor using nonstatistical sampling compute a corresponding sample size using statistical theory.

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:* Smaller Sample Size	Larger Sample Size	Related Factor for Substantive Sample Planning
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
c. Assessment of risk related to other substantive procedures directed at the same assertion (including substantive analytical procedures and other relevant substantive procedures)	Low assessment of risk associated with other relevant substantive procedures	High assessment of risk associated other relevant substantive procedures	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 For additional details on audit sampling, including detailed tables, auditors may refer to AICPA Audit Guide *Audit Sampling* and the appendix of AU section 350.

.59 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. 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.

.60 *Evaluating the Sample Results*. The misstatement in the sample should 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).

.61 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).

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AAM Section 5500

Suggested Supplemental Reference Materials

.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 (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 into two sections: General Standards—generally applicable to all enterprises and 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.

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[*] On January 15, 2008, the Financial Accounting Standards Board (FASB) launched the one-year verification phase of the *FASB Accounting Standards Codification*™ (codification). After the verification period, during which constituents are encouraged to provide feedback on whether the codification content accurately reflects existing U.S. generally accepted accounting priniciples (GAAP) for nongovernmental entities, the FASB is expected to formally approve the codification as the single source of authoritative U.S. GAAP, other than guidance issued by the Securities and Exchange Commission (SEC). The codification includes all accounting standards issued by a standard-setter within levels A through D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force, and related literature. The codification does not change GAAP; instead it reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics, and displays all topics using a consistent structure. The SEC guidance will follow a similar topical structure in separate SEC sections.

This edition of the *Audit and Accounting Manual* (AAM) has not been conformed to the new codification. The AICPA AAM, as well as other AICPA literature, will be conformed to reflect the codification after the verification phase and upon formal approval by the FASB.

- **Accounting Trends & Techniques (AICPA)**

  This publication contains reporting methods based on a cumulative survey, as well as significant accounting presentations, discussions, and trends. By following the lead of these industry front-runners, practitioners can apply the latest techniques and improve their own reporting performance.

- **Fraud Detection in a GAAS Audit (Revised edition) (AICPA)**

  This practice aid provides CPAs with the most recent information related to complying with AU section 316, Consideration of Fraud in a Financial Statement Audit *(AICPA,* Professional Standards, *vol. 1).*

- **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.

- **Standard Form to Confirm Account Balance Information with Financial Institutions (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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[*] On January 15, 2008, the Financial Accounting Standards Board (FASB) launched the one-year verification phase of the *FASB Accounting Standards Codification*™ (codification). After the verification period, during which constituents are encouraged to provide feedback on whether the codification content accurately reflects existing U.S. generally accepted accounting prinicples (GAAP) for nongovernmental entities, the FASB is expected to formally approve the codification as the single source of authoritative U.S. GAAP, other than guidance issued by the Securities and Exchange Commission (SEC). The codification includes all accounting standards issued by a standard-setter within levels A through D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force, and related literature. The codification does not change GAAP; instead it reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics, and displays all topics using a consistent structure. The SEC guidance will follow a similar topical structure in separate SEC sections.

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AAM Section 6000
Audit Documentation

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AAM Section 6100

Audit Documentation—General

.01 Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions reached by the auditor in the engagement. Audit documentation, also known as working papers, may be recorded on paper or on electronic or other media. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance on the form, general content, and ownership and confidentiality of audit documentation.

.02 Other Statements on Auditing Standards (SASs) contain specific documentation requirements and can be found in appendix A of AU section 339. Additionally, specific documentation or document retention requirements may be included in other standards (for example, government auditing standards), laws, and regulations applicable to the engagement.

.03 The auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached. Audit documentation provides the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with generally accepted auditing standards and provides the principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

.04 Among other matters, AU section 339 provides the following:

- The auditor should prepare audit documentation in connection with each engagement in sufficient detail to provide an experienced auditor with no previous connection to the audit a clear understanding of the work performed (including the nature, timing, extent and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached.
- Oral explanations on their own do not represent sufficient support for the work the auditor performed or conclusions the auditor reached, but may be used by the auditor to clarify or explain information contained in the audit documentation.
- The auditor should document significant findings or issues, actions taken to address them (including any additional evidence obtained), the basis for the final conclusions reached, discussions of the significant findings or issues with management or others, including responses and when and with whom the discussion took place. If the auditor has identified information that contradicts or is inconsistent with the auditor's final conclusions regarding a significant finding or issue, the auditor should document how the auditor addressed the contradiction or inconsistency.
- The auditor should assemble the audit documentation to form the final audit engagement file on a timely basis, but within 60 days following the report release date (also known as the documentation completion date). After this date, the auditor must not delete or discard audit documentation before the end of the specified retention period and should appropriately document any subsequent additions. (Paragraphs .23–.30 of AU section 339 provide information regarding revisions to audit documentation after the date of the auditor's report.)
- A file retention period should not be shorter than five years from the report release date.

Audit Documentation Retention

.05 AU section 339 states that the auditor should adopt reasonable procedures to retain and access 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. Such retention period, however, should not be shorter than five years from the report release date. Statutes, regulations, or the audit firm's quality control policies may specify a longer retention period.

.06 Determining the proper periods for retaining records is a major decision for practitioners. Records may 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 generally correspond with the longest statute of limitations prevailing in each state for breach of contract, breach of fiduciary duty, and professional liability claims.

.07 Audit documentation may be retained permanently or for periods corresponding with the longest state statute of limitations, as noted in the previous paragraph. Generally, certain audited financial statement working paper data, such as accounts receivable confirmations, are destroyed after 10 years. Examples of audit documentation that the auditor may wish to retain permanently include auditor's reports, reports filed with the Securities and Exchange Commission, tax returns for current clients, and audit documentation for current clients. Some firms divide the retention period into 2 parts, records are first filed in the office and later placed in storage (for example, 3 years in the office and then permanently in storage). Other records, such as audit documentation files for former clients, may be retained for 3 years in the office, 7 years in storage, and then destroyed after the retention period has ended. The auditor may obtain specific approval of the engagement partner before destroying any audit documentation. An annual schedule may be established for reviewing and purging firm data. Because there is substantial variation in the retention periods used by firms, each firm may carefully consider its requirements and consult with legal counsel before adopting a retention period.

.08 For further guidance on record retention, see the AICPA *Management of an Accounting Practice Handbook* (product no. 090407).

Ownership and Confidentiality of Audit Documentation

.09 Audit documentation is the property of the auditor, and some states recognize this right of ownership in their statutes.

.10 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.

.11 Whether audit documentation is in paper, electronic, or other media, the integrity, accessibility, and retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the auditor's knowledge or could be permanently lost or damaged. Accordingly, the auditor should apply appropriate and reasonable controls for audit documentation to

a. clearly determine when and by whom audit documentation was created, changed, or reviewed;

b. protect the integrity of the information at all stages of the audit, especially when the information is shared within the audit team or transmitted to other parties via electronic means;

c. prevent unauthorized changes to the documentation; and

d. allow access to the documentation by the audit team and other authorized parties as necessary to properly discharge their responsibilities.

Documentation of Departures From the SASs

.12 In rare circumstances, when the auditor departs from a presumptively mandatory requirement in the SASs, he or she must document the justification for the departure and how the alternative procedures in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement.

General Discussion

.13 These sections present points of view on the organization and preparation of audit documentation.

.14 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 eliminate, therefore, the need for examining the same documents twice to obtain necessary information. The form, content, and extent of audit documentation are matters of the auditor's professional judgment and depend on the circumstances of the engagement and the audit methodology and tools used. The individual preferences of auditors and firms may be informal common practices or expressed as part of a firm's formal policies and procedures. A firm may consider the nature of its practice and the services commonly provided to its clients, in addition to professional standards in developing its procedures and policies on audit documentation. Those procedures and policies may permit the flexibility necessary to meet the needs of individual engagements.

[*The next page is 6201.*]

AAM Section 6200

Form, Content, and Extent of Audit Documentation

.01 The form, content, and extent of audit documentation vary 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 Examples of audit documentation are audit programs, analyses, issues, memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail), and schedules or commentaries prepared or obtained by the auditor. Abstracts or copies of the entity's records should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. Audit documentation may be in paper form, electronic form, or other media.

.03 The auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand

a. the nature, timing, and extent of auditing procedures performed to comply with Statements on Auditing Standards and applicable legal and regulatory requirements, including (1) who performed the audit work and the date such work was completed and (2) who reviewed specific audit documentation and the date of such review;

b. the results of the audit procedures performed and the audit evidence obtained;

c. the conclusions reached on significant matters; and

d. that the accounting records agree or reconcile with the audited financial statements or other audited information.

.04 In determining the form, content, and extent of audit documentation, the auditor should consider the following factors:

- The nature of the auditing procedures to be performed
- The identified risk of material misstatement associated with the assertion or account or class of transactions, including related disclosures
- The extent of judgment involved in performing the work and evaluating the results
- The significance of the audit evidence obtained to the assertion being tested
- The 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 or evidence obtained

Basic Elements of Format

.05 Audit documentation formats generally include at least the following for identification purposes:

- A title or heading composed 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

.06 In instances when audit documentation extends beyond one page, some auditors present the heading on only the lead page and 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 preestablished 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 6300, *Organization and Filing (Indexing)*.)

.07 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

.08 Some auditors prefer to identify client preparation of schedules and analysis by notations or codes, such as PBC (prepared by client), rather than use a detailed signature and reference block.

General Considerations

.09 The following are some general considerations on audit documentation content that may be helpful:

- The auditor may include identification of the (*a*) source of the information presented (for example, fixed assets ledger or cash disbursements journal), (*b*) the nature and extent of the work done and conclusions reached (by symbols and legend, narrative, or a combination of both), and (*c*) appropriate cross-references to other working papers in the content of an individual working paper or group of related papers.
- The auditor should document significant findings or issues, actions taken to address them, and the basis for the final conclusions reached. If for some reason the auditor leaves the assignment before resolving all items, he or she may 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, the auditor may wish to refrain from using vague judgmental adjectives such as *good* or *bad*. Conclusions should be supported by documented facts, especially if they concern the adequacy of the client's records.
- Working papers are an integrated presentation of information. The auditor may find it useful to cross-reference working papers to call attention to inter-account relationships and to reference a paper to other working papers summarizing or detailing related information.

- 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

.10 As mentioned in the preceding section, abstracts or copies of the entity's records should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. Additionally, audit documentation of procedures performed, including tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation should include the identifying characteristics of the specific items tested.

.11 Furthermore, the auditor should document significant findings or issues, actions taken to address them (including any additional evidence obtained), and the basis for the final conclusions reached. Significant audit findings or issues include, but are not limited to, the following:

- Significant matters involving the selection, application, and consistency of accounting principles with regard to the financial statements, including related disclosures. Such matters include, but are not limited to (1) accounting for complex or unusual transactions or (2) accounting 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 a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause significant difficulty in applying auditing procedures that the auditor considered necessary.
- Findings that could result in modification of the auditor's report.
- Audit adjustments. For purposes of AU section 339, an audit adjustment is a correction of a misstatement of the financial information that is identified by the auditor, whether or not recorded by management, that could, either individually or when aggregated with other misstatements, have a material effect on the company's financial information.

Timesaving Considerations

.12 There are a number of ways to save time and avoid unnecessary detail in audit documentation preparation. For example, the auditor may consider the following examples:

- 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 a detailed audit program that 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 or prepaid 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 the 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.
- Use symbols (tick marks) whenever possible, especially when the same symbol applies to several working papers.

Symbols (Tick Marks)

.13 When using symbols, it may 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, it is important that each symbol 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.
- Simple, distinctive, and clear symbols can be quickly written by the preparer and easily identified by a reviewer.

.14 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.

.15 The most commonly used symbols 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 6301.*]

AAM Section 6300

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 while 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 may 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 filing 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, see the following table:

	Two Possible Alternatives	
Working trial balance—assets	B/S-A	T/B-1
Working trial balance—liabilities	B/S-L	T/B-2
Working trial balance—income and 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 that might result in the following classification scheme for the preceding examples for cash:

	Using Letters and Numbers	*Using Only Numbers*
Lead schedule	(A)	(10)
Primary detail schedules	(A-1) (A-2) and so forth	(10-1) (10-2) and so forth
Secondary detail schedules	(A-1-1) (A-1-2) (A-1-3)	(10-1-1) (10-1-2)
	(A-2-1) (A-2-2) (A-2-3)	(10-2-1) (10-2-2)

.05 Predetermined (standardized) indexing systems may be printed on separate pages for reference during the performance of field work and insertion in the front of 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 (for example, cash or accounts receivable) with the related working papers 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 (for example, 1 of 10, 2 of 10, and so forth), because 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, and so forth. Documentation, such as supporting confirmations and lists of outstanding checks, would be assigned index numbers commencing with 2001.1, 2001.2, and so forth. 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, 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 that it is better to classify all audit documentation 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 carry forward in nature. Regardless of the approach used, it is important to recognize that the provisions of AU section 339 apply to current year audit documentation maintained in *any* type of file (this includes permanent files) if such documentation serves as support for the current year's audit report.

.13 The requirements and guidance in AU section 339 also apply to permanent files. Accordingly, permanent files should be reviewed and updated, as needed, in conjunction with the annual audit. Examples of documents that may be found in permanent files are listed in paragraph .07 of AAM section 6100.

Practice Tip

The audit documentation files should contain copies of final executed documents when needed to enable an experienced auditor to understand the work performed and conclusions reached. Any drafts or unsigned versions of documents should be replaced with final versions.

Index Topics

.14 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:

Planning and administration

- Time and budget data
- General correspondence and memos
- Memos—current
- Notes and copies for use in next engagement
- Engagement letters
- Schedules and analyses to be prepared by client
- Minutes
- Checklist of an administrative nature if required by firm policy

Audit or work program[1]

Matters of continuing concern

- Client's industry—background
- Description and brief history of client
- Data and ratio analysis of client's operations

---

[1] Alternate practices of filing audit programs include

(*a*) putting the program in a binder that is separate and distinct from current and permanent files;

(*b*) putting the signed-off program in the current file; and

(*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.

- Client's facilities
- Articles of incorporation
- Bylaws
- Current contracts and agreements
  - — Debt agreements
  - — Leases
  - — Labor contracts
  - — Agreements with officers and key people
  - — Pension plans
  - — Profit-sharing plans
  - — Stock warrants
  - — Stock options
  - — Other agreements
  - — Client's accounting policies and procedures
  - — Carryforward analyses[2]

Internal control

- Internal control questionnaire, narrative, flowcharts, and so forth[3]
- Initial assessment of control risk memos
- Tests of controls

Reports, financial statements and footnotes, trial balances, and assembly sheets

- Reports and financial statements (including letters, 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 and work sheets[4]

Assets

---

[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.

- Cash
- Marketable securities (and related income)
- Notes receivable (and related interest)
- Accounts receivable
  - Summary and analyses
  - Confirmation procedures[5] [6]
- Allowance for doubtful accounts and notes[7]
- Inventories
  - Summary and analysis
  - Price tests, cost, and market
  - Obsolescence review
  - Observation, test counts, and cutoff data
  - Last in, first out determinations
- Prepaid expenses
- Other current assets
- Investments
- Property, plant and accumulated depreciation, and depletion and amortization[8]
- Intangible deferred charges and amortization[9]
- Other assets
- Intercompany accounts

Liabilities

- Notes payable (and related interest)
- Accounts payable
- Accrued liabilities other than income taxes
- Accrued income taxes (both current and deferred), related provisions, and credits[10]
  - Federal
  - State and local
- Other current liabilities
- Long-term debt (including current maturities and capitalized leases)[11]
- Other long-term liabilities
- Deferred income[12]

Commitments and contingencies

---

[5] See footnote 2.

[6] For situations involving voluminous 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).

[7] See footnote 2.

[8] See footnote 2.

[9] See footnote 2.

[10] See footnote 2.

[11] See footnote 2.

[12] See footnote 2.

- Attorney's letters
- Abstractors of commitments and contingencies noted during review of minutes, contracts and agreements, confirmation responses, and so forth
- Subsequent events review
- Management representation letter

Equity (capital accounts)[13]

- Capital stock
- Additional paid-in capital
- Treasury stock
- Retained earnings
- Partnership capital

Revenue and expenses

- Operating revenues
- Cost of sales
- Selling, general and administrative
- Other operating expenses
- Other income
- Other expense
- Extraordinary and unusual items
- Secondary schedules
  - — Maintenance and repairs
  - — Taxes other than income taxes
  - — Rents
  - — Royalties
  - — Advertising costs
  - — Legal fees
  - — Interest expense recap

[*The next page is 7001.*]

[13] See footnote 2.

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 could 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 may then be stuffed in envelopes and submitted to the post office under the auditor's control.[1]

.06 The auditor should control the mailings and receipt of responses so that the confirmation process is independent of the client.

.07 The auditor may consider including the firm's office or post office box number as the return address on mailing envelopes 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 may be 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.

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[1] In April 2007, the AICPA issued Auditing Interpretation No. 1, "Use of Electronic Confirmations," of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 9330 par. .01–.06). This interpretation states that properly controlled electronic confirmations may be considered to be reliable audit evidence and discusses auditor considerations when using electronic confirmations.

.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 following account numbers, statement(s) of our account(s) and the related paid checks for the period from [*balance sheet date*] to [*two weeks subsequent to the balance sheet date*] inclusive.

Account Number	*Account Name*
______________________	______________________
______________________	______________________
______________________	______________________

Sincerely,
[*Name of Customer*]

____

By:____________________

Notes:

(A) This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or who 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 could 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 the following:

- 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 in cluding titles and account numbers).
- Confirmation of the list of authorized signers for the listed 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

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.

Approved 1990 by American Bankers Association, American Institute of Certified Public Accountants, and Bank Administration Institute. Additional forms available from: AICPA—Order Department, P.O. Box 1003, NY, NY 10108-1003

D 451 5951

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

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of the petty cash fund (or amount of advances) in your possession as of December 31, 20XX which was shown by our records as $_______.

Please indicate in the following space provided 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.

Sincerely,

[*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:[1] [2]

[*If a list is not obtained from the client, the auditor may complete the following for each account:*

Name of Account	*Account No.*[3]	*Amount Held*
1.________________	___________________	___________________
2.________________	___________________	___________________
3.________________	___________________	___________________]

Please also indicate to the auditors whether or not 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.

Sincerely,

[*Client's Authorized Signature*]

[1] This letter may be expanded, if necessary, to request cutoff statements of activity (principal and interest) in the accounts.

[2] 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.

[3] Use the custodian or trustee's account number.

.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.

Sincerely,

[*Client's Authorized Signature*]

Notes:

(A) The request may 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 date range*] for the accounts listed in the following space provided:

Date and Time: ___________________ Signed: ______________________________

Title: ______________________________

Notes:

(A) The auditor may request that receipt(s) 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*]

[*Date*]

[*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."

If the amount is not in agreement with your records, please check and complete "B."

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.

Sincerely,

[*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, who are now conducting an audit of our financial statements.

[*Name of auditors*]

____

[*Address of auditors*]

____

____

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 may 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 following space provided and then 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 following space provided the particulars shown in your records along with any information that may help reconcile the difference from our records. Payments should not be sent to the auditors.

Sincerely,

[*Client's Authorized Signature*]

The above information is correct as of [*date*] with the following exceptions (if any):

____

____

____

____

____

____

Signed: ____________________ Date: ____________________

.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 as of [*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, or other unit)
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. A statement of any known liens against this merchandise.
5. The 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.

Sincerely,

[*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 it was 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. A statement of any known liens against these goods.

5. The 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.

Sincerely,

[*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,

____
(Name of owner as shown on policy contract)

By ______________________________
Authorized Signature

REPORT FROM INSURANCE COMPANY [ ]

[ ]

Information requested as of: ______________
(Date)

Additional forms available from
AICPA-ORDER
PO BOX 0946
NYC, NY 10108-0946

		Policy #1	Policy #2	Policy #3
	A. Policy Number			
	B. Insured-Name(s)			
	C. Beneficiaries as Shown on Policies (If Verification Requested in Item 11)			
1 Face Amount of Basic Policy				
2 Values Shown as of (Insert Date If Other Than Date Requested)				
3 Premiums, Including Prepaid Premiums, Are Paid to (Insert Date)				
4 Policy Surrender Value (Excluding Dividends, Additions & Indebtedness Adjustments)				
5 Surrender Value of All Dividend Credits, Including Accumulations & Additions				
6 Termination Dividend Currently Available on Surrender				
7 Other Surrender Values Available to Policy Owner	a. Prepaid Premium Value			
	b. Premium Deposit Funds			
	c. Other			
8 Outstanding Policy Loans, Excluding Accrued Interest				
9 If Any Policy Loans Exist, Complete Either "a" or "b"	a. Interest Accrued on Loans			
	b1. Loan Interest is Paid to (Enter Date)			
	b2. Interest Rate is (Enter Rate)			
NOTE: PLEASE ANSWER ANY ITEM(s) 10–12 INDICATED BY A (✓).				
☐ 10 Is There an Assignee of Record? (Enter Yes or No)				
☐ 11 Is Beneficiary of Record as Shown in Item C. Above? (Enter Yes or No*)		*	*	*
☐ 12 Is the Name of Policy Owner (Subject to Any Assignment) as Shown on Top of Form: ☐ Yes ☐ No If No, Enter Name of Policy Owner of Record:				

* If Answer to Item 11 is "No." Please Give Name of Beneficiary or Date of Last Beneficiary Change:

Yours truly, (Insurance Company)

ORIGINAL
To be mailed to accountant

______________ Date

______________________________ Authorized Signature - Title

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,

____
(Name of owner as shown on policy contract)

By ______________________________
Authorized Signature

REPORT FROM INSURANCE COMPANY [ ]

[ ]

Information requested as of: ______________
(Date)

Additional forms available from
AICPA-ORDER
PO BOX 0946
NYC, NY 10108-0946

		Policy #1	Policy #2	Policy #3
	A. Policy Number			
	B. Insured-Name(s)			
	C. Beneficiaries as Shown on Policies (If Verification Requested in Item 11)			
1 Face Amount of Basic Policy				
2 Values Shown as of (Insert Date If Other Than Date Requested)				
3 Premiums, Including Prepaid Premiums, Are Paid to (Insert Date)				
4 Policy Surrender Value (Excluding Dividends, Additions & Indebtedness Adjustments)				
5 Surrender Value of All Dividend Credits, Including Accumulations & Additions				
6 Termination Dividend Currently Available on Surrender				
7 Other Surrender Values Available to Policy Owner	a. Prepaid Premium Value			
	b. Premium Deposit Funds			
	c. Other			
8 Outstanding Policy Loans, Excluding Accrued Interest				
9 If Any Policy Loans Exist, Complete Either "a" or "b"	a. Interest Accrued on Loans			
	b1. Loan Interest is Paid to (Enter Date)			
	b2. Interest Rate is (Enter Rate)			
NOTE: PLEASE ANSWER ANY ITEM(s) 10–12 INDICATED BY A (✓).				
☐ 10 Is There an Assignee of Record? (Enter Yes or No)				
☐ 11 Is Beneficiary of Record as Shown in Item C. Above? (Enter Yes or No*)		*	*	*
☐ 12 Is the Name of Policy Owner (Subject to Any Assignment) as Shown on Top of Form: ☐ Yes ☐ No If No, Enter Name of Policy Owner of Record:				

* If Answer to Item 11 is "No." Please Give Name of Beneficiary or Date of Last Beneficiary Change:

Yours truly, (Insurance Company)

DUPLICATE

______________ Date

______________________________ Authorized Signature - Title

.15 Pension Plan Actuarial Information

FASB Statement No. 132R, *Employers' Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106*, 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 as follows as it pertains to the XYZ Pension Plan, which is a defined benefit plan. For your convenience and in response to those requests, you may supply pertinent sections, properly signed and dated, of your actuarial 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 percentages of the plan's assets that are invested in debt securities, equity securities, real estate, and any additional classifications of investment. Please identify the target compositions, if any, for the aforementioned classifications of investment groups.
4. A narrative description of the plan's investment policies and strategies, and the basis used to determine the expected long term rate of return on plan assets.
5. The method and the amortization period, if any, used for the following:
   a. Calculation of a market related value of plan assets, if different from the fair value
   b. Amortization of any transition asset or obligation
   c. Amortization of unrecognized prior service cost
   d. Amortization of unrecognized net gain or loss
6. Any substantive commitments for benefits that exceed the benefits defined by the written plan that are included in the calculations.
7. Determination of the value of any insurance or annuity contracts included in the assets.
8. Nature and effect of significant plan amendments and other significant matters affecting comparability of net periodic pension cost, funded status, and other information for the current period with that for the prior period.
9. The following information relating to the employee census data used in calculating the benefit obligations and pension cost:

a. The source and nature of the data is ____________________ and the date as of which the census data was collected is __________________.

b. The following information concerning participants:

Participants	Number of Persons	Compensation (if applicable)
Currently receiving payments	________	________
Active with vested benefits	________	________
Terminated with deferred vested benefits	________	________
Active without vested benefits	________	________
Other (describe)	________	________

Note: *If information is not available for all the above categories, please indicate the categories that have been grouped and describe any group or groups of participants excluded from the above information.*

c. Information for the following individuals contained in the census:

Participant's Name or Number	Age or Birth Date	Sex	Salary	Date Hired or Years of Service

Note to Auditor: *The auditor may 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 or 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, *Employers' Accounting for Pensions*—transition obligation or (asset)		________
d. Amount of loss (or gain) recognized due to a settlement or curtailment		________

* Financial Accounting Standards Board (FASB) recently issued Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*. FASB Statement No. 158 amends FASB Statements No. 87, 88, 106, and 132(R). The intent of the statement is to improve financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year end balance sheet, with some exceptions. An employer with publicly traded equity securities is required to disclose the status of a defined pension plan as of the fiscal year ending after December 15, 2006. An entity without publicly traded equity securities should disclose the status of the plan for fiscal years ending after December 15, 2006, but before June 15, 2007.

e. Net total of components (*a+b+c+d*)	$	________
5. Net periodic pension cost: (1+2-3+4*e*)	$	________

6. The above measurement of the net periodic pension cost is based on the following assumptions:

Weighted average discount rate	________%
Weighted average rate of compensation increase	________%
Weighted average expected long term rate of return on plan assets	________%

Please describe the basis on which the above rates were selected and whether the basis is consistent with the prior period.

Please briefly describe the other assumptions used in the above measurement.

7. The calculations of the items shown in B1 and B5 are based on the following:

Asset information	________
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–B5.

C. Please provide the following information for disclosure in the financial statements for the period ending ______________:

			Estimated
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 or liability that is recognized pursuant to paragraph 35 may result in a temporary difference, as defined by FASB Statement No. 109, *Accounting for Income Taxes*. The deferred tax effects of any temporary differences shall be recognized in income tax expense or benefit for the year and shall be allocated to various financial statement components, including other comprehensive income, pursuant to paragraphs 35–39 of FASB Statement No. 109.		________
9.	The amount of any accumulated other comprehensive income or liability that is recognized pursuant to paragraph 35 may result in a temporary difference, as defined by FASB Statement No. 109. The deferred tax effects of any temporary differences shall be recognized in income tax expense or benefit for the year and shall be allocated to various financial statement components, including other comprehensive income, pursuant to paragraphs 35–39 of FASB Statement No. 109.		________
10.	The amount included in other comprehensive income for the period arising from a change in the minimum pension liability recognized in accordance with FASB Statement No. 158, *Employers' Accounting for Post Retirement Benefit Plans*.		________

(continued)

	Estimated	
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–C10 is based on the following:		
Asset information	________	
Census data	________	
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–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–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 eliminated significant risks related to the obligation and assets,
4. any events that significantly reduced the expected years of future service of employees,
5. any events that eliminated for a significant number of employees the accrual of defined benefits for some or all of their future service, or
6. any special or contractual termination benefits offered to employees.

F. Please provide the amounts of anticipated cash payments for benefits for each of the next 5 years, as well as the expected aggregate amount of benefit payments for the subsequent 5 year period (years 6–10).

G. Was all of the information above determined in accordance with FASB Statement No. 87, as amended, FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, as amended, and FASB Statement No. 89, *Financial Reporting and Changing Prices*, as amended (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.

H. 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*].

Sincerely,
[*Client's Authorized Signature*]

.16 Pension Plan Assets Held by Trustee

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Trustee or Custodian*]

[*Address*]

Our auditors [*name and address of auditor*] are conducting an audit of our financial statements. Accordingly, please provide our auditors directly with a listing of the assets including market values as of [*date*] for our employees' pension trust [*title and trustee's account number*].

Please also provide the auditors with the following information about our employees' pension trust for the period from [*beginning of period*] to [*end of period*]:[4]

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.

Sincerely,
[*Client's Authorized Signature*]

[4] 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 (for example, demand provisions and prepayment penalties)		________	
Any other direct or contingent liabilities to you (please write "None" or provide description)		________	

If the above information is in agreement with your records at that date, please so indicate by signing in the following space provided 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 following space provided the particulars shown in your records and any information that may help reconcile the difference from our records.

Sincerely,
[*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 (for example, prepayment penalties and demand provisions)		__________	

A return envelope is enclosed for your reply.

Sincerely,

[*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.

Sincerely,

[*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*] that 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 a statement of the nature of defaults, if any

A return envelope is enclosed for your reply.

Sincerely,

[*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 paragraph .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*] that 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.

Sincerely,

[*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.

Sincerely,

[*Client's Authorized Signature*]

The above information agrees with our records at [*balance sheet date*] with the following

____

____

____

____

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 paragraph .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.

Sincerely,

[*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 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 (1) the number of shares issued to each of specifically mentioned officers and directors, (2) specified information about shareholders owning more than a stated percent of the total outstanding shares, and (3) 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 following space provided 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.

Sincerely,

[*Client's Authorized Signature*]

____

Account No.	*Date*	*Balance*

Date:___________________________ Signed:___________________________

.25 Confirmation of Contingent Liabilities

[*Date*]

Financial Institution Official[†]

First United Bank
Anytown, USA 00000

In connection with an audit of the financial statements of [*name of customer*] as of [*balance sheet date*] and for the [*period*] then ended, we have advised our independent auditors of the following listed information, which we believe is a complete and accurate description of our contingent liabilities, including oral and written guarantees, with your financial institution. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other contingent liabilities, including oral and written guarantees, from your financial institution comes to your attention, please include such information in the following space provided.

Name of Maker	Date of Note	Due Date	Current Balance

Interest Rate	Date Through Which Interest is Paid	Description of Collateral	Description of Purpose of Note

Information related to oral and written guarantees is as follows:

____

____

____

____

Please confirm whether the information about contingent liabilities presented above is correct by providing a signature below and returning this directly to our independent auditors [*name and address of CPA firm*].

Sincerely,

[*Name of Customer*]

____

By: ______________________________

[*Authorized Signature*]

____

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

Dear CPA Firm:

The above information listing contingent liabilities, including oral and written guarantees, agrees with the records of this financial institution.[‡] Although we have not conducted a comprehensive, detailed search of our records, no information about other contingent liabilities, including oral and written guarantees, came to our attention. (Note exceptions below or in an attached letter.)

____

____

____

____

____

____
[*Name of Financial Institution*]

By: ________________________ ______________
[*Officer*] [*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.[5]

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.[6]

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

---

[||] This letter should be addressed to a financial institution official who is responsible for the financial institution's relatioknship 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.

[5] This is 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.

[6] This is applicable only if the financial institution has applied sanctions during the [*period*] or notified the Company that sanctions may be applied. Indicate details.

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 in the following space provided 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 in the following space provided or in an attached letter.)

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____

____

____

____

____
[*Name of Financial Institution*]

By: ______________________________ ________________
[*Officer*] [*Date*]

____
[*Title*]

.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 following information that 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 in the following space provided.

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 _____ percent.

Compensating balance arrangements are:

____

____

____

____

This line of credit supports commercial paper (or other borrowing arrangements) as described in the following space provided:

____

____

____

Please confirm whether the information about lines of credit presented above is correct by signing in the following space provided and returning this letter directly to our independent auditors [*name and address of CPA Firm*].

Sincerely,

[*Name of Client*]

____

By: ________________________________

[*Authorized Signature*]

[#] This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the 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.

____

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 in the following space provided or in an attached letter.)

____

____

____

____

____
[*Name of Financial Institution*]

By: ____________________________ ________________
[*Officer*] [*Date*]

____
[*Title*]

.28 Related Party Confirmation

In certain situations, the auditor may want to confirm the existence of related parties with directors, principal officers, major shareholders, or others. For example, a company does not have adequate controls and processes in place to identify related party transactions and the auditor has not otherwise been satisfied as to the extent of related party transactions. The following is an illustrative related party confirmation letter that an auditor may use when the auditor is not otherwise satisfied as to the extent of related party transactions.

[*Date*]

[*Name of Director, Principal Officer, or Major Stockholder*]

[*Address*]

Dear [*Name*]:

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 stamped, addressed 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 the Company.

Please answer all questions. If the answer to any question is "yes," please explain why it is so. Certain terms used in the questions are defined at the end of the questionnaire. Please read the definitions carefully before answering the questions. Thank you for your cooperation.

Sincerely,

____

[*Client's Authorized Signature*]

____

[*Title*]

[*Client Name*]

Related Party Questionnaire

Please answer all questions. If the answer to any question is "yes," please explain why it is so. Certain terms used in the questions are defined at the end of the questionnaire. Please read the definitions carefully before answering the questions.

1. Have you or any related party of yours had any interest, direct or indirect, in any sales, purchases, transfers, leasing arrangements, 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 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) is, 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 correct to the best of my knowledge and belief.

[*Signature*] [*Date*]

Definitions

company. Parent company, any subsidiary or investee for which investments are accounted for by the equity method

related party. Any (1) party (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 the voting interests; (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; (3) any member of your immediate family; and (4) other party with which you may deal if you (or the other party) control or can significantly influence the other to an extent that either of you might be prevented from fully pursuing your own separate interests.

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.

party. An individual, a corporation, a partnership, an association, a joint stock company, a business trust, or an unincorporated organization.

beneficial owner. Party 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 party's name. Examples of beneficial ownership include securities held for the party'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 party owns substantially all of the stock. Shares (1) held (individually or in a fiduciary capacity) by the party's spouse, the party's or his or her spouse's minor children, or a relative of the party or his or her spouse who shares the same home with the party; or (2) as to which the party can vest or revest 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*]

[*Name*]

[*Address*]

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 following space provided if the previous statement 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.

Sincerely,

____

[*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*]

[*Name*]

[*Address*]

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 in the following space provided:

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 following 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.

Sincerely,

____
[*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[1]

.01 Illustrative Inquiry Letter to Legal Counsel[2]

[*Prepared on Client's Letterhead*][3]

[*Date*][4]

[*Name of Lawyer*]

[*Address of Lawyer*]

Dear [*Name*]: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 disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure

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[1] If a client has not needed to retain legal counsel, the auditor may express an unqualified opinion on the financial statements even though he or she has not obtained a letter from legal counsel of the Company. In these circumstances, the auditor may consider obtaining written representation from the Company that legal counsel has not been retained for matters concerning business operations that may involve current or prospective litigation.

[2] Extracted from AU section 337A, *Illustrative Audit Inquiry Letter to Legal Counsel*, the appendix to AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1). (See footnote 4.)

[3] Paragraph .09 of AU section 337 discusses the matters that should be covered in a letter of audit inquiry.

[4] Sending of this letter should be timed so that the lawyer's response is dated as close to the auditor's opinion date as practical. However, the auditor and client may consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

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.]

Sincerely,

[*Authorized Signature for Client*]

.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 (for example, 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 FASB 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 FASB 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 with 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.]

Sincerely,

[*Authorized Signature for Client*]

Notes:

(A) Paragraph .09 of AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1), discusses the matters that should be covered in a letter of audit inquiry.

(B) The 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 may 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, the auditor may consider obtaining a written representation 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 paragraph .10 of AU section 337 provides for such a conference. However, to improve the auditor's ability to receive all of the information necessary to complete his or her audit, he or 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 or 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 (1) the proceedings, (2) the claim(s) asserted, (3) the amount of monetary damages sought, or if no amounts are indicated in preliminary case filings, a statement to that effect, and (4) 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 or 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 or her.

[*The next page is 7401.*]

AAM Section 7400

Management Representations and Representation Letters

.01 AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), states that written representations from management should be obtained 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.[1]

.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 audit evidence 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 (GAAP), 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 GAAP.

b. Management's belief that the financial statements are fairly presented in conformity with GAAP.

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.

[1] The AICPA recently released Technical Practice Aid Technical Questions and Answers (TIS) section 9100 paragraph .06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*). Auditors may find this nonauthoritative practice aid useful when conducting audits in accordance with generally accepted auditing standards (GAAS). This practice aid discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The practice aid indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.

Recognition, Measurement, and Disclosure

g. Management's belief that the effects of any uncorrected financial statement misstatements[2] 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.[3] (A summary of such items should be included in or attached to the letter.)[4]

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 (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids*, ACC sec. 10,640).

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*.[5]

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.

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[2] Paragraph .07 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), states that a misstatement can result from errors or fraud and provides guidance for the auditor's evaluation of audit findings. (See AU section 312 par. .50–.61.)

[3] If management believes that certain 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*]").

[4] AU section 312 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.

[5] 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" of AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 9337 par. .15-.17).

Materiality Considerations

.04 Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on materiality for this purpose. Materiality may be different for different representations. A discussion of materiality may be included explicitly in the representation letter, in either qualitative or quantitative terms. Materiality considerations would not apply to those representations that are not directly related to amounts included in the financial statements.

Addressing and Dating

.05 The written representations should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the representations should be made as of 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 GAAP, 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 AU section 316, *Consideration of Fraud in a Financial Statement Audit*, (AICPA, *Professional Standards*, vol. 1), and *related parties* in footnote 1 of AU section 334, *Related Parties* (AICPA, *Professional Standards*, vol. 1). 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 .08 of AU section 333.

.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 in 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 [*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 FASB Statement No. 5.[6]

    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 .07* and appendix B, of AU section 333.]

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[6] In the circumstances discussed in footnote 7 of AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), 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 (FASB) Statement No. 5, *Accounting for Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

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 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; and
- whether subsequent events require adjustments to the fair value measurements and disclosures are included in the financial statements.

[Source: Paragraph .49 of AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1)]

See appendix C of AU section 722, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1), for "Illustrative Management Representation Letters for a Review of Interim Financial Information."

.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 SOP 94-6. (*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 FASB Statement No. 5.[7]

   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.

---

[7] Footnote 7 of AU section 333 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 AU section 333, 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, and we have not consulted a lawyer concerning litigation, claims, or assessments.

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)

.15 Illustrative Representation Letter to Other Accountants

[*Firm's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

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 that, in our judgment, would have a material effect upon the financial statements covered by your report, we shall notify you promptly.

Sincerely,

____

[*Engagement Partner's Signature*]

Note:

If any matters come to the firm's attention that may require revision of the previous financial statements, they could 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*]

[*Name*]

[*Address*]

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, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec.101 par. .01), of the Code of Professional Conduct.

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 the following:

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*].

Sincerely,

____

[*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 AU section 333. 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 Those Charged With Governance

.01 AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements. The term *those charged with governance* means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. For entities with a board of directors, the term encompasses the term *board of directors* or *audit committee* used elsewhere in generally accepted auditing standards (GAAS). Recognizing the importance of effective 2-way communication to the audit, AU section 380 provides a framework for the auditor's communication with those charged with governance and identifies some specific matters to be communicated with them.

Matters to Be Communicated

.02 In accordance with paragraph .05 of AU section 380, the auditor must communicate with those charged with governance matters related to the financial statement audit that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. The auditor should communicate the following with those charged with governance:

a. The auditor's responsibilities under GAAS, including that

  (1) the auditor is responsible for forming and expressing an opinion about whether the financial statements that have been prepared by management with the oversight of those charged with governance are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP); and

  (2) the audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

These responsibilities may be communicated through the engagement letter, or other form of contract that records the terms of the engagement, if that letter or contract is provided to those charged with governance. See paragraphs .26–.28 of AU section 380 for additional guidance.

b. An overview of the planned scope and timing of the audit. See paragraphs .29–.33 of AU section 380 for additional guidance.

c. Significant findings from the audit, including

  (1) the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures (see paragraphs .37–.38 of AU section 380);

  (2) significant difficulties, if any, encountered during the audit (see paragraph .39 of AU section 380);

  (3) uncorrected misstatements, other than those the auditor believes are trivial, if any (see paragraphs .40–.41 of AU section 380);

  (4) disagreements with management, if any (see paragraph .42 of AU section 380); and

(5) other findings or issues, if any, arising from the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their oversight of the financial reporting process.

.03 Unless all of those charged with governance are involved in managing the entity, the auditor also should communicate the following:

a. Material, corrected misstatements that were brought to the attention of management as a result of audit procedures. The auditor also may communicate other corrected immaterial misstatements, such as frequently recurring immaterial misstatements that may indicate a particular bias in the preparation of the financial statements.

b. Representations the auditor is requesting from management. The auditor may provide those charged with governance with a copy of management's written representations.

c. Management's consultations with other accountants (see paragraph .43 of AU section 380).

d. Significant issues, if any, arising from the audit that were discussed, or were the subject of correspondence, with management (see paragraph .44 of AU section 380).

The Communication Process

.04 The auditor should communicate with those charged with governance the form, timing, and expected general content of communications. Clear communication of the auditor's responsibilities, an overview of the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication. Matters that may also contribute to effective two-way communication include discussion of the following:

- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are in a better position to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form in which communications will be made.
- The person(s) on the audit team and among those charged with governance who will communicate regarding particular matters.
- The auditor's expectation that communication will be two-way, and that those charged with governance will communicate with the auditor matters they consider relevant to the audit. Such matters might include strategic decisions that may significantly affect the nature, timing, and extent of audit procedures; the suspicion or the detection of fraud; or concerns about the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.
- The process for taking action and reporting back on matters communicated by those charged with governance.

.05 The auditor should communicate in writing with those charged with governance significant findings from the audit when, in the auditor's professional judgment, oral communication would not be adequate. This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved. Other communications may be oral or in writing. When the auditor communicates matters in accordance with AU section 380 in writing, the auditor should indicate in the communication that it is intended solely for the information and use of those charged with governance and, if appropriate, management; and is not intended to be and should not be used by anyone other than these specified parties. When matters required to be communicated have been communicated orally, the auditor should document them. When matters have been communicated in writing, the auditor should retain a copy of the communication. Documentation of oral communication may include a copy of minutes prepared by the entity if those minutes are an appropriate record of the communication.

.06 The auditor should communicate with those charged with governance on a sufficiently timely basis to enable those charged with governance to take appropriate action. The appropriate timing for communications will vary with the circumstances of the engagement. Considerations include the significance and nature of the matter, and the action expected to be taken by those charged with governance.

.07 The auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor should take appropriate action to address the effectiveness of the communication process.

Additional Communication Requirements

.08 Requirements for the auditor to communicate with those charged with governance are included in other standards, including the following:

a. Paragraph .17 of AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), to communicate with the audit committee or others with equivalent authority and responsibility illegal acts that come to the auditor's attention.

b. Paragraph .22 of AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1), to communicate to management and the audit committee (or others with equivalent authority and responsibility) when the auditor becomes aware during an audit in accordance with GAAS that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, and that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements.

c. Paragraph .22 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), to inquire directly of the audit committee (or at least its chair) regarding the audit committee's views about the risks of fraud and whether the audit committee has knowledge of any fraud or suspected fraud affecting the entity.

d. Paragraph .79 of AU section 316 to communicate with those charged with governance fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements. In addition, the auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with those charged with governance about misappropriations perpetrated by lower level employees.

e. Paragraph .20 of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), to communicate in writing to management and those charged with governance control deficiencies identified during an audit that upon evaluation are considered significant deficiencies or material weaknesses. See examples in the following paragraphs. In addition, refer to AAM section 8300, *Understanding SAS No. 112 and Evaluating Control Deficiencies*, for further guidance.

.09 Report on Reportable Conditions

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 communication 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.

Sincerely,

____
[*Engagement Partner*]

.10 Written Communication Regarding Significant Deficiencies and Material Weaknesses Identified During an Audit of Financial Statements

[*Date of Auditor's Report on the Financial Statements*]

In planning and performing our audit of the financial statements of [*client's name*] as of and for the year ended [*financial statement date*], in accordance with auditing standards generally accepted in the United States of America, we considered [*client's name*] internal control over financial reporting *internal control* as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control. Accordingly, we do not express an opinion on the effectiveness of the company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed in the following sections, we identified certain deficiencies in internal control that we consider to be significant deficiencies and a deficiency that we consider to be a material weakness.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the following deficiencies to be significant deficiencies in internal control.

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 recorded in a timely manner 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 him or 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 $ [*amount*] 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 significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the following deficiency constitutes 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.

Sincerely,

____

[*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 [*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 (GAAS). 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, GAAS does 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 [*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 [*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*]

[*Name*]

[*Address*]

Dear [*Name*]:

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 20XX. We have [*number of*] partners and [*number of*] 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 [*type of*] 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.

[*Name*], 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 $[*amount*], 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 [*number*] with questions about this proposal.

Sincerely,

____
[*Firm Signature*]

[*The next page is 8001.*]

AAM Section 8000
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—2007/08

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
AUDIT RISK ALERT—2007/08

This Audit Risk Alert is intended to provide auditors with an overview of recent economic, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

Christopher Cole, CPA, CFE
Technical Manager
Accounting and Auditing Publications

Amy M. Eubanks, CPA
Director
Accounting and Auditing Publications

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits. This alert can also be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory 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 financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 To help auditors understand relevant industry, economic, and regulatory factors affecting their clients, the AICPA offers industry and topic-specific alerts to be used in conjunction with this alert. These alerts can be obtained by calling the AICPA at (888) 777-7077 or going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The client financial statements you audit will be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic, and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the entity's financial statements being audited.

Real Gross Domestic Product

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, GDP increased at an annual rate of 2.9 percent in 2006, consistent with the pace of growth experienced in 2005 when GDP increased by 3.1 percent. During the first quarter of 2007, GDP increased by an annual rate of only 0.6 percent. However, according to second quarter final estimates, GDP increased at an annual rate of 3.8 percent.

.11 The increase in real GDP in the second quarter of 2007 reflects positive contributions for services, exports, nonresidential structures, federal and state and local government spending, and equipment and software sales. These positive contributions were partly offset by negative contributions for residential fixed investments. Imports decreased.

Unemployment

.12 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, with an annual average rate of 4.6 percent representing approximately 7 million people. The 2006 rates represent the lowest annual rate and total number of jobless since 2000, according to the U.S. Department of Labor (DOL), Bureau of Labor Statistics. Through the third quarter of 2007, the unemployment rate averaged 4.5 percent. These data further demonstrate the economic growth the United States has experienced since the beginning of 2006.

Interest Rates

.13 After a period of rising rates during the first half of 2006, the Federal Reserve kept its target for the federal funds rate at 5.25 percent for 10 consecutive meetings (June 2006–August 2007). At that time, the Federal Reserve indicated future federal fund rate adjustments would likely depend upon the outlook for economic growth and inflation. Since its August 2007 meeting and in response to shaky financial market conditions, the Federal Reserve has taken several action steps. It announced that it would provide reserves as necessary through the open market to facilitate the orderly functioning of financial markets by promoting trading in the federal funds market at rates close to the 5.25 percent target rate. On August 17, 2007, it announced that financial market conditions had deteriorated and tighter credit conditions and increased uncertainty have the potential to restrain economic growth. Then at its September and October meetings, the Federal Reserve decided to lower its target for the federal funds rate 50 and 25 basis points, respectively, to 4.50 percent citing increased uncertainty surrounding the economic outlook. The Federal Reserve also decided to decrease the discount rate 50 and 25 basis points, respectively, to 5.00 percent to consistently keep the spread between the primary credit rate and the target federal funds rate at 50 basis points. Auditors should remain alert to developments in the financial markets and how they may affect your audit engagements. Issues for auditors to consider include that the change in, and the volatility of, interest rates increase the inherent risk for the valuation of investments and derivatives whose value is significantly affected by interest rates. Auditors may need to determine that the recorded value of an investment or derivative uses reasonable interest rates in cases where the interest rate affects valuation.

Consumer Price Index Trends

.14 The U.S. DOL Bureau of Labor Statistics annually publishes its Consumer Price Index for all Urban Consumers (CPI-U). The CPI-U is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. The CPI-U is the most widely used measure of inflation and is sometimes viewed as an indicator of the effectiveness of government economic policy. It provides information about price changes in the nation's economy to government, business, labor, and private citizens and is used by them as a guide when making economic decisions. The table below shows the U.S. city annual average CPI-U for the past five years. The baseline years are: 1982–1984=100.

Year	*Annual Average CPI-U*	*Change From Prior Year*
2002	179.9	1.6%
2003	184.0	2.3%
2004	188.9	2.7%
2005	195.3	3.4%
2006	201.6	3.2%

Interest Rates for Below-Market Rate Loans

.15 The Internal Revenue Service (IRS) issues the blended annual Applicable Federal Rate each year to provide guidance in relation to Internal Revenue Code section 7872(e)(2), *Treatment of loans with below-market interest rates—Foregone interest* (U.S. Code, Title 26). The term *forgone interest* means, with respect to any period during which the loan is outstanding, the excess of—

a. the amount of interest, which would have been payable on the loan for the period, if interest accrued on the loan at the applicable federal rate and were payable annually on the day referred to in subsection (a)(2), over

b. any interest payable on the loan properly allocable to such period.

.16 This rate is a useful guide to auditors in evaluating interest rates and determining imputed interest for below-market-rate loans. The following table provides the blended annual rate for each of the previous five years as determined by the IRS.

Year	*Blended Annual Rate*
2003	1.52%
2004	1.98%
2005	3.11%
2006	4.71%
2007	4.92%

Housing Market

.17 The housing market continues to deteriorate and is not only slowing the economy directly, but rising concerns over falling home prices may encourage customers to cut back on their spending in the future. There is continued concern that inflation may begin to accelerate in our economy. After five years of record sales and growth, the residential real estate market slowed, and the outlook has since been bleak. The number of foreclosure filings reported in the United States in August 2007 more than doubled versus August 2006 and increased 36 percent from July 2007; a trend that signals homeowners are increasingly unable to make timely payments on their mortgages. The Mortgage Bankers Association reports that 550,000 homeowners with subprime loans began a foreclosure process over the last year and specialists say that number could double over the next couple of years.

Subprime Mortgages and the Liquidity Crisis

.18 In recent months, there has been a sharp rise in the rate of delinquency and default by subprime mortgage loan borrowers. This has occurred most frequently when the borrower on an adjustable-rate loan is unable to make the higher payments required after an interest-rate adjustment, and is unable to either refinance the loan or sell the home for an amount sufficient to pay off the mortgage. Moreover, several hundred billion dollars of adjustable-rate subprime mortgage loans are expected to "reprice" over the 15- to

18-month period beginning in October 2007. As a consequence, many industry observers expect that the rates of default—and foreclosure—will continue to increase sharply. The difficulties arising from increasing defaults have been further compounded by declining real estate prices, especially in geographic areas that have a large volume of subprime mortgage loans. In many areas, rising foreclosures have contributed to the declining prices of residential real estate. The rising level of defaults, combined with the falling price of the related real estate collateral, has resulted in significant increases in credit losses and fear by investors that those losses will continue to grow for the foreseeable future.

Market Reaction

.19 Most subprime loans were ultimately financed by investors who purchased securities backed by the underlying subprime mortgage loans. These securities vary widely in terms of their exposure to loss from defaults on the underlying loans. The level of defaults has, in many cases, exceeded the model-based projections originally used to structure and assign ratings to securities backed by subprime mortgage loans, and has led to a significant number of downgrades. As a result of the uncertainty in the marketplace arising from current conditions, investors and lenders have largely retreated from investments in assets backed by subprime mortgage loans, creating a so called "liquidity crisis." With a sharply reduced number of investors in the marketplace willing to provide funding, many subprime mortgage lenders have been forced to cease originations of new mortgages, and holders of existing loans and mortgage-backed securities have experienced sharp declines in their value. Lenders that are still making new loans have significantly tightened their underwriting standards, making it more difficult for existing borrowers to refinance.

Contagion Effect—Spread of Illiquidity to Other Markets

.20 In recent weeks, the "liquidity crisis" has spread to other corners of the credit markets. Investors have pulled back from investments in collateralized bond obligations (many of which are backed by subordinated mortgage-backed securities backed by subprime mortgage loans), high-yield "junk" bonds, debt issued in leveraged buyout transactions, and even short-term, asset-backed commercial paper. It is not possible at this time to predict how long investors will stay on the sidelines or which markets will be most affected, but it is not unreasonable to expect—especially for subprime mortgage-related assets—that current conditions could persist for an extended period of time until the uncertainty is reduced, that is, when it becomes clear that defaults have peaked and real estate prices have bottomed out.

Valuation Issues

.21 Assets backed by subprime mortgage loans (and other assets affected by the market disruptions) are held by all types of entities—including, but not limited to, commercial and investment banks, insurance companies, investment companies such as mutual funds and hedge funds, pension and employee-benefit plans, and university endowment funds. In short, these assets can be found in investment portfolios across the spectrum. These assets may be held either directly, or indirectly, such as through an investment company such as a mutual fund or a hedge fund.

.22 Investors in a variety of assets have experienced severe price volatility as a result of the increased credit risk and the reduced liquidity in the marketplace. That volatility has given rise to questions about how to measure the fair value of subprime-mortgage-related assets, as well as other assets affected by the illiquidity in today's market. Fair value is an essential component of many accounting principles that underlie companies' financial reporting, not only when fair value is the primary basis of accounting—such as for trading accounts and held-for-sale portfolios—but also for purposes of measuring and reporting asset impairment, and for making disclosures about fair value.

Audit and Attestation Issues and Developments

.23 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.24 The Public Company Accounting Oversight Board (PCAOB) establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the Securities and Exchange Commission (SEC) and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A), to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120) • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report

SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	The risk assessment standards are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier application permitted.
• SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")* (AICPA, *Professional Standards*, vol. 1, AU sec. 230)	• This statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230A).
• SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	• This statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A).
• SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)	• This statement supersedes SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326A).
• SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)	• This statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312A).
• SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)	• This statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 310), and supersedes SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A).
• SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314)	• This statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

(continued)

• SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1, AU sec. 318)	• This statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
• SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)	• This statement amends SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350A).
SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) Issue date: December 2005 (Applicable to audits conducted in accordance with GAAS)	SAS No. 103 supersedes SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339A) and amends AU section 530, *Dating of the Independent Auditors Report* (AICPA, *Professional Standards*, vol. 1). Effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted, this SAS establishes standards and provides guidance to an auditor of a nonissuer on audit documentation.
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325.01–.04), which interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.

Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330.01–.06), which interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.
TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current years audit report.
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This PA responds to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.
AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This PA provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditors report.

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PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This standard replaces the PCAOB's previous internal control standard, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.
PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client's audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the SEC or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm's independence, and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524. This rule is effective for audits of fiscal years ending on or after November 15, 2007.
PCAOB Conforming Amendments to the Interim Auditing Standards Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in Appendix 3 of PCAOB Release No. 2007-005A at www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.
PCAOB Report, *Report on the Second-Year Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report is based on PCAOB inspections that looked at parts of approximately 275 audits of internal control over financial reporting by registered public accounting firms. Inspections focused on four areas: integrating the audits of financial statements and internal control, using a top-down approach, using the work of others, and assessing risk.

PCAOB Report, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 300—Report on the Initial Implementation of Auditing Standard No. 2") Issue Date: January 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report focuses on aspects of the PCAOB's interim auditing standards that address the auditor's responsibility with respect to fraud, specifically AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.
PCAOB Staff Questions and Answers, *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	Topics covered include the following: • The application of Rule 3522(a) when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm • Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction • Whether a registered public accounting firms independence is affected by the IRS's subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b) • Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself • Clarification of the term *other change in employment event* as it relates to Rule 3522(c)
PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 100—PCAOB Staff Questions and Answers") Issue Date: October 2006 (Applicable to audits conducted in accordance with PCAOB standards)	The guidance provides direction for auditing a company's estimation of the fair value of stock options granted to employees pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment*, which became applicable for financial statements of companies with fiscal years ending on or after June 15, 2006.

The Auditor's Communication With Those Charged With Governance

.25 In December 2006, the Auditing Standards Board (ASB) issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and is effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to entities that either have an audit committee or have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.26 SAS No. 114 recognizes the importance of effective two-way communication to the audit. It provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires significant matters communicated with those charged with governance to be documented.

Identifying Those Charged With Governance

.27 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those 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.

.28 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.29 Because there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditors understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.30 In May 2006, the AICPA ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. The new SAS is applicable

whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued, the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. However, with the adoption of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), the PCAOB redefined these terms, which now differ from SAS No. 112.

- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditors classification of the deficiency.

- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, and identifies indicators that control deficiencies should be regarded as a significant deficiency or a material weakness.

- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.

- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.

- Contains illustrative written communications to management and those charged with governance.

How Revisions of SAS No. 112 Affect Practice

.31 As auditors gain a better understanding of what needs to be communicated to management and those charged with governance, there may be more control deficiencies that are identified as significant deficiencies and material weaknesses and that are then communicated to management and those charged with governance. Auditors may emphasize and therefore spend more time evaluating identified control deficiencies than in the past.

Discussions With Management and Others

.32 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. Auditors may have to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor who does not provide attest services for the client can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving managements internal control objectives.

.33 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of material weaknesses. Another reason is that auditors have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in written communication as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.34 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented, detected, and corrected by the client.

Issues for Audits of Smaller Entities

.35 One issue that has arisen in audits of smaller entities is the increase in costs as a result of the time the auditor spends documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.36 Another issue that has caused concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, detecting, or correcting material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, because doing so would impair independence.[1] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.37 The requirements of SAS No. 112 introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing (ISA).

.38 The AICPA has published the AICPA Audit Risk Alert titled *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in implementation of this SAS. That alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; that alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

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[1] See Ethics Interpretation No. 101-3, "Performance of nonattest services," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

AICPA Risk Assessment Standards

.39 In March 2006, the ASB issued eight SASs referred to as the risk assessment standards (SAS Nos. 104–111). The SASs became effective for audits of financial statements for periods beginning on or after December 15, 2006. Although the SASs include many of the underlying concepts and detailed performance requirements contained in existing standards, they do create significant new requirements for the auditor. The primary objective of the SASs is to enhance your application of the audit risk model in practice by requiring, among other things:

- A more in-depth understanding of your audit client and its environment, including its internal control. This knowledge will be used to identify the risks of material misstatement in the financial statements (whether caused by error or fraud) and what the client is doing to mitigate them.
- A 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.

Key Provisions of the SASs and How They Differ From Previous Standards

.40 The following tables list the key provisions of the eight risk assessment standards and provide summaries of how these standards differ from previous AICPA generally accepted auditing standards (GAAS).

SAS No. 104, **Amendment to Statement on Auditing Standards No. 1,** *Codification of Auditing Standards and Procedures* **("Due Professional Care in the Performance of Work")**

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 104 defines *reasonable assurance* as a "high level of assurance."	• SAS No. 104 clarifies the meaning of reasonable assurance.

SAS No. 105, **Amendment to Statement on Auditing Standards No. 95,** *Generally Accepted Auditing Standards*

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 105 expands the scope of the understanding that the auditor must obtain in the second standard of field work from "internal control" to "the entity and its environment, including its internal control." • The quality and depth of the understanding to be obtained is emphasized by amending its purpose from "planning the audit" to "assessing the risk of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures."	• Previous guidance considered the understanding of the entity to be a part of audit planning, and emphasized that the understanding of internal control also was primarily part of audit planning. • By stating that the purpose of your understanding of the entity and its internal control is part of assessing the risk of material misstatement, SAS No. 105 essentially considers this understanding to provide audit evidence that ultimately supports your opinion on the financial statements.

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Key Provisions	*How the SAS Differs From Current Standards*
	• The new standard emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures. It is anticipated that "generic" audit programs will not be an appropriate response for all engagements because risks vary between entities. • The term *further audit procedures*, which consists of test of controls and substantive tests, replaces the term *tests to be performed* in recognition that risk assessment procedures are also performed. • The term *audit evidence* replaces the term *evidential matter*.

SAS No. 106, Audit Evidence

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 106 defines *audit evidence* as "all the information used by the auditor in arriving at the conclusions on which the audit opinion is based."	• Previous guidance did not define audit evidence. • SAS No. 106 also describes basic concepts of audit evidence. • The term *sufficient, appropriate audit evidence*, defined in SAS No. 106, replaces the term *sufficient, competent evidence.*
• SAS No. 106 recategorizes assertions by classes of transactions, account balances, and presentation and disclosure; expands the guidance related to presentation and disclosure; and describes how the auditor uses relevant assertions to assess risk and design audit procedures.	• SAS No. 106 recategorizes assertions to add clarity. • *Assertion relating to presentation and disclosure* has been expanded and includes a new assertion that information in disclosures should be "expressed clearly" (understandability).
• SAS No. 106 defines *relevant assertions* as those assertions that have a meaningful bearing on whether the account is fairly stated.	• The term *relevant assertions* is new, and it is used repeatedly throughout SAS No. 106.
• SAS No. 106 provides additional guidance on the reliability of various kinds of audit evidence.	• The previous standard included a discussion of the competence of evidential matter and how different types of audit evidence may provide more or less valid evidence. SAS No. 106 expands on this guidance.
• SAS No. 106 identifies "risk assessment procedures" as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement at the financial statement and relevant assertion levels.	• SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risk of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately support the auditor's opinion on the financial statements.

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 106 provides that evidence obtained by performing risk assessment procedures, as well as that obtained by performing tests of controls and substantive procedures, is part of the evidence the auditor obtains to draw reasonable conclusions on which to base the audit opinion, although such evidence is not sufficient in and of itself to support the audit opinion.	
• SAS No. 106 describes the types of audit procedures that the auditor may use alone or in combination as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor.	• Risk assessment procedures include: — Inquiries of management and others within the entity — Analytical procedures — Observation and inspection
• SAS No. 106 includes guidance on the uses and limitations of inquiry as an audit procedure.	• Inquiry alone is not sufficient to evaluate the design of internal control and to determine whether it has been implemented.

SAS No. 107, Audit Risk and Materiality in Conducting an Audit

Key Provisions	*How the SAS Differs From Current Standards*
• The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of: 1. Determining the extent and nature of risk assessment procedures. 2. Identifying and assessing the risk of material misstatement. 3. Determining the nature, timing, and extent of further audit procedures. 4. Evaluating whether the financial statements taken as a whole are presented fairly, in conformity with generally accepted accounting principles.	• Previous guidance said that auditors "should consider" audit risk and materiality for certain specified purposes. SASs state that the auditor "must" consider. • New guidance explicitly states that audit risk and materiality are used to identify and assess the risk of material misstatement.
• Combined assessment of inherent and control *risks* is termed the *risk of material misstatement*.	• SAS No. 107 consistently uses the term *risks of material misstatement*, which often is described as a combined assessment of inherent and control risk. However, auditors may make separate assessment of inherent risk and control risks.

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Key Provisions	*How the SAS Differs From Current Standards*
• The auditor should assess the risk of material misstatement as a basis for further audit procedures. Although that risk assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. • Assessed risks and the basis for those assessments should be documented.	• SAS No. 107 states that the auditor should have and document an appropriate basis for the audit approach. • These two provisions of the risk assessment standards effectively eliminate the ability of the auditor to assess control risk "at the maximum" without having a basis for that assessment. In other words, you can no longer "default" to maximum control risk.
• The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management.	• SAS No. 107 provides additional guidance on communicating misstatements to management. • The concept of not accumulating misstatements below a certain threshold is included in the previous standards, but SAS No. 107 provides additional, specific guidance on how to determine this threshold.
• The auditor should request management to respond appropriately when misstatements (known or likely) are identified during the audit.	• SAS No. 107 provides specific guidance regarding the appropriate auditor's responses to the types of misstatements (known or likely) identified by the auditor.

SAS No. 108, Planning and Supervision

Key Provisions	*How the SAS Differs From Current Standards*
SAS No. 108 provides guidance on: • Appointment of the independent auditor. • Establishing an understanding with the client. • Preliminary engagement activities. • The overall audit strategy. • The audit plan. • Determining the extent of involvement of professionals possessing specialized skills. • Using a professional possessing information technology (IT) skills to understand the effect of IT on the audit. • Additional considerations in initial audit engagements. • Supervision of assistants.	• Much of the guidance provided in SAS No. 108 has been consolidated from several existing standards. • However, SAS No. 108 provides new guidance on preliminary engagement activities, including the development of an overall audit strategy and an audit plan. — The overall audit strategy is what previously was commonly referred to as the audit approach. It is a broad approach to how the audit will be conducted, considering factors such as the scope of the engagement, deadlines for performing the audit and issuing the report, and recent financial reporting developments. — The audit plan is more detailed than the audit strategy and is commonly referred to as the audit program. The audit plan describes in detail the nature, timing, and extent of risk assessment and further audit procedures you perform in an audit. • SAS No. 108 states that you should obtain a written understanding with your client.

SAS No. 109, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 109 describes audit procedures that the auditor should perform to obtain the understanding of the entity and its environment, including its internal control.	• The auditor should perform "risk assessment procedures" to gather information and gain an understanding of the entity and its environment. These procedures include inquiries, observation, inspection, and analytical procedures. Previous standards did not describe the procedures that should be performed to gain an understanding of the client. • Information about the entity may be provided by a variety of sources, including knowledge about the entity gathered in previous audits (provided certain conditions are met), and the results of client acceptance and continuance procedures. • SAS No. 109 also directs the auditor to perform a variety of risk assessment procedures, and it describes the limitations of inquiry.
• The audit team should discuss the susceptibility of the entity's financial statements to material misstatement.	• Previous standards did not require a "brainstorming" session to discuss the risk of material misstatements. SAS No. 109 requires such a brainstorming session, which is similar (and may be performed together with) the brainstorming session to discuss fraud.
• The purpose of obtaining an understanding of the entity and its environment, including its internal control, is to identify and assess "the risk of material misstatement" and design and perform further audit procedures responsive to the assessed risk.	• SAS No. 109 directly links the understanding of the entity and its internal control with the assessment of risk and design of further audit procedures. Thus, the understanding of the entity and its environment, including its internal control, provides the audit evidence necessary to support the auditor's assessment of risk.
• SAS No. 109 states the auditor should assess the risk of material misstatement at both the financial statement and relevant assertion levels.	• The previous standard included the concept of assessing risk at the financial statement level, but SAS No. 109 provides expanded and more explicit guidance. • SAS No. 109 also directs the auditor to determine how risks at the financial statement level may result in risks at the assertion level.
• SAS No. 109 provides directions on how to evaluate the design of the entity's controls and determine whether the controls are adequate and have been implemented.	• Under the previous standard, the primary purpose of gaining an understanding of internal control was to plan the audit. Under SAS No. 109, your understanding of internal control is used to assess risks. Thus, the understanding of internal control provides audit evidence that ultimately supports the auditors opinion on the financial statements.

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Key Provisions	*How the SAS Differs From Current Standards*
	• The previous standard directs the auditor to obtain an understanding of internal control as part of obtaining an understanding of the entity and its environment. SAS No. 109 requires auditors to evaluate the design of controls and determine whether they have been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. It is anticipated that this phase of the audit will require more work than simply gaining understanding of internal control.
• SAS No. 109 directs the auditor to consider whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.	• Previous standard did not include the concept of "significant risks." • Significant risks exist on most engagements. • The auditor should gain an understanding of internal control and also perform substantive procedures for all identified significant risks. Substantive analytical procedures alone are not sufficient to test significant risks.
• SAS No. 109 provides extensive guidance on the matters that should be documented.	• The guidance provided by SAS No. 109 relating to documentation is significantly greater than that provided by previous standards.

SAS No. 110, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 110 provides guidance on determining overall responses to address the risk of material misstatement at the financial statement level and the nature of those responses.	• The concept of addressing the risk of material misstatement at the financial statement level and developing an appropriate overall response is similar to the requirement in previous standards relating to the consideration of audit risk at the financial statement level. However, that guidance was placed in the context of audit planning. SAS No. 110 "repositions" your consideration of risk at the financial statement level so you make this assessment as a result of and in conjunction with your performance of risk assessment procedures. In some cases, this assessment may not be able to be made during audit planning. • SAS No. 110 requires you to consider how your assessment of risks at the financial statement level affect individual financial statement

Key Provisions	*How the SAS Differs From Current Standards*
	assertions, so that you may design and perform tailored further audit procedures (substantive tests or tests of controls). • The list of possible overall responses to the risk of material misstatement at the financial statement level also has been expanded.
• Further audit procedures, which may include tests of controls, or substantive procedures should be responsive to the assessed risk of material misstatement at the relevant assertion level.	• Although the previous standards included the concept that audit procedures should be responsive to assessed risks, this idea was embedded in the discussion of the audit risk model. The SASs repeatedly emphasize the need to provide a clear linkage between your understanding of the entity, your risk assessments, and the design of further audit procedures. • SAS No. 110 requires you to document the linkage between assessed risks and further audit procedures, which was not a requirement under the previous standards.
• SAS No. 110 provides guidance on matters the auditor should consider in determining the nature, timing, and extent of such audit procedures.	• The new guidance on determining the nature, timing, and extent of tests of controls and substantive tests has been expanded greatly and addresses issues that previously were not included in the authoritative literature. • SAS No. 110 states that the nature of further audit procedures is of most importance in responding to your assessed risk of material misstatement. That is, increasing the extent of your audit procedures will not compensate for procedures that do not address the specifically identified risks of misstatement. • SAS No. 110 states that you should perform certain substantive procedures on all engagements. These procedures include: — Performing substantive tests for all relevant assertion related to each material class of transactions, account balance, and disclosure regardless of the assessment of the risk of material misstatements. — Agreeing the financial statements, including their accompanying notes, to the underlying accounting records. — Examining material journal entries and other adjustments made during the course of preparing the financial statements.

SAS No. 111, Amendment to Statement on Auditing Standards No. 39, Audit Sampling

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 111 provides guidance relating to the auditor's judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls.	• SAS No. 111 provides enhanced guidance on tolerable misstatement. In general, tolerable misstatement in an account should be less than materiality to allow for aggregation in final assessment. • SAS No. 111 revises AU section 350, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1) to state that sample sizes determined using either statistical or nonstatistical methods would ordinarily be comparable in size.

.41 Whether due to error or fraud, the new risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks that may lead to a material misstatement in the client's financial statements and any mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations (COSO) of the Treadway Commission's framework at www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs will most likely result in significant changes to firm audit methodologies and the training of personnel. Therefore, it is recommended that auditors allow ample time in advance of the required implementation date. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Companion Audit Guide

.42 In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Audit Documentation

.43 In December 2005, the ASB issued SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339). This SAS establishes standards and provides guidance to auditors of nonissuers on audit documentation; it supersedes SAS No. 96 of the same name. Audit documentation is an essential element of audit quality and although audit documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate audit documentation contributes to the quality of an audit.

.44 In developing this SAS, the ASB considered the documentation requirements of PCAOB Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"); the International Auditing and Assurance Standards Boards (IAASB) ISA No. 230 (Revised), *Audit Documentation*, issued in September 2005; *Government Auditing Standards* issued by the Comptroller General of the United States; and suggestions from the National Association of State Boards of Accountancy. Accordingly, the requirements of the SAS are similar, in most respects, to the requirements of PCAOB Auditing Standard No. 3 and ISA No. 230 (Revised).

.45 Among other things, this SAS:

- Requires the auditor to prepare audit documentation for each engagement in sufficient detail to provide an experienced auditor, having no previous connection to the audit, with a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached.

- Provides enhanced guidance on matters that should be documented. For example, in addition to the former requirements of SAS No. 96 that the auditor document audit findings or issues that in his or her judgment are significant, actions taken to address them (including any additional evidence obtained), and the basis for the final conclusions reached, SAS No. 103 requires the auditor to document discussions of significant findings or issues with management and others, on a timely basis, including when and with whom the discussions took place.

- States that oral explanations on their own do not represent sufficient support for the work the auditor performed or conclusions the auditor reached, but may be used by the auditor to clarify or explain information contained in the audit documentation.

- Requires the auditor to document audit evidence that is identified as being contradictory or inconsistent with the final conclusions, and how the auditor addressed the contradiction or inconsistency.

- Requires the auditor to assemble the audit documentation to form the final audit engagement file within 60 days following the report release date. After that date, the statement requires the auditor not to delete or discard existing audit documentation and to appropriately document any subsequent additions.

- Specifies a minimum file retention period of five years from the report release date. (The terms of the engagement or state law or regulation may specify a longer retention period.)

.46 SAS No. 103 also amends paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1). See the section of this alert titled "Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance*" for further discussion of this aspect of SAS No. 103. Also, see the following section of this alert titled "Audit Documentation Technical Practice Aids," which refers to two AICPA Technical Practice Aids (TPA). These TPAs address issues related to audit documentation. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2006.

Audit Documentation Technical Practice Aids

.47 In May 2007, the ASB issued two TPA Technical Questions and Answers (TIS) related to SAS No. 103.

.48 TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.49 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*), discusses whether the provisions of SAS No. 103 related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current years audit report.

Practice Alert No. 07-1, *Dating of the Auditors Report and Related Practical Guidance*

.50 As mentioned previously in this alert, a key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530 to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms, an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.51 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date
- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.52 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf. Readers should also note the PITF is currently working on a practice alert that addresses auditing and other considerations related to electronic information that it plans to issue during the third quarter of 2007.

PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*

.53 On May 24, 2007, the PCAOB adopted Auditing Standard No. 5 that supersedes Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, and an independence rule relating to the auditor's provision of internal-control-related, nonaudit services. It also adopted certain amendments to its interim standards. The SEC approved the standard on July 25, 2007.

.54 The PCAOB has closely monitored the implementation of Auditing Standard No. 2, and came to two conclusions:

1. The audit of internal control over financial reporting has produced significant benefits related to corporate processes and controls.

2. These benefits have come at a significant, higher than anticipated cost, and, at times, the effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

.55 The PCAOB adopted the new Auditing Standard No. 5 to replace Auditing Standard No. 2 with the primary objective of focusing the auditor on matters most important to internal control. Goals of this new standard are to eliminate unnecessary procedures, to simplify and shorten the standard by reducing detail and specificity, and to make the audit more scalable for smaller and less complex companies. Some examples of important differences between Auditing Standard No. 5 and Auditing Standard No. 2 follow:

- The new standard is less prescriptive, with fewer mandatory requirements and more reliance on auditor judgment.
- The new standard makes the audit scalable, so it can change to fit the size and complexity of any company.
- The new standard directs the auditor to focus on what matters most and eliminates unnecessary procedures from the audit.
- The new standard includes a principles-based approach to determining when and to what extent the auditor can use the work of others.

.56 The new standard will do the following, among other things:

- Direct the auditor to the most important controls and emphasize the importance of risk assessment using a top-down approach
- Emphasize fraud controls, with an emphasis on assessing fraud risk in the planning process and additional guidance on the types of controls that may address fraud risk
- Identify management fraud as an area of higher risk, directing the auditor to focus more attention in this area
- Recalibrate the walkthrough requirement
- Permit consideration of knowledge obtained during prior audits
- Revise the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness
- Adopt communication requirements, which require, among other things, that the auditor consider and communicate any identified significant deficiencies to the audit committee
- Direct the auditor to tailor the audit to reflect attributes of smaller and less complex companies
- Remove the requirement to evaluate management's process, which the PCAOB believes could contribute to a checklist approach to compliance by the auditors
- Provide auditors with further guidance regarding scoping decisions for multiple location audits

.57 Auditing Standard No. 5 is effective for audits of internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002 for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted at any point after SEC approval. Auditors who elect to comply with Auditing Standard No. 5 after July 25, 2007, but before its effective date, must also comply, at the same time, with newly adopted PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*), and other PCAOB standards as amended by Auditing Standard No. 5. Auditors who elect to comply with Auditing Standard No. 5 before its effective date should use the definition of *material weakness* contained in Auditing Standard No. 5. See www.pcaob.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.5.aspx for the full release document.

.58 Upon approval of the new standard by the SEC on July 25, 2007, the PCAOB announced that it is undertaking several initiatives to support the successful implementation of the standard. These initiatives include working closely with the audit firms, early in their process, as they evaluate how the new standard will affect their firms' audits of internal control. Other initiatives include continued outreach to public companies and smaller audit firms regarding the new standard. See full text of the press release at www.pcaob.org/News_and_Events/News/2007/07-25.aspx.

Considering and Using the Work of Others

.59 At the time the PCAOB proposed Auditing Standard No. 5 for public comment, the PCAOB also proposed an auditing standard titled *Considering and Using the Work of Others*, which would have superseded AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*). However, after considering all comments, the PCAOB decided to retain AU section 322 for both the financial statement audits and audits of internal control over financial reporting and incorporate language into Auditing Standard No. 5 that establishes integration concepts rather than adopting the proposed standard. Some of the key concepts in Auditing Standard No. 5 as they relate to using the work of others are as follows:

- Allows the auditor to use the work of others to obtain evidence about the design and operating effectiveness of controls for both the internal control audit and the financial statement audit, eliminating a barrier to integration of the two audits
- Eliminates the principal evidence provision
- Allows the auditor to use the work of company personnel, other than internal auditors, as well as third parties working under the direction of management or the audit committee
- Requires the auditor to use a risk-based approach to the extent that the auditor can use the work of others

.60 For additional information, see paragraphs 16–19 of Auditing Standard No. 5 at www.pcaob.org/Rules/Rules_of_the_Board/Auditing_Standard_5.pdf.

PCAOB Rule 3525, Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

.61 The PCAOB also adopted a new rule related to the auditor's responsibilities when seeking audit committee preapproval of internal control-related nonaudit services. The rule is intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence. Specifically, the public accounting firm shall describe, in writing, the scope of the service and submit to the audit committee, as well as discuss with the audit committee, the potential effects of the service on the firms independence. Registered firms are also required to document the substance of such discussions in writing. This rule is effective for audits of fiscal years ending on or after November 15, 2007 (the same effective date as Auditing Standard No. 5). The full text of this rule can be found at www.pcaob.org/Rules/Rules_of_the_Board/Rule_3525.pdf.

Conforming Amendments to Interim Auditing Standards

.62 In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments due to the issuance of Auditing Standard No. 5 can be found at www.pcaob.org/Rules/Rules_of_the_Board/Conforming_Amendments_AS5.pdf.

Audit Considerations for Alternative Investments

.63 Over the past several years, certain not-for-profit organizations, healthcare entities, pension plans and investment companies—including hedge funds and funds of funds—have dramatically increased their investment in financial instruments that do not have a readily determinable market value. These investments are commonly referred to as alternative investments and, in many cases, have greater risk and volatility than other investments. For example, the value of investments related to subprime loans have reportedly declined significantly based on recent developments (discussed previously in this alert), including, but not limited to, decreased liquidity for such investments. Investments related to subprime loans may be in the form of direct holdings of subprime loans or ownership of entities or investment vehicles whose value is affected by the value of subprime loans, such as investments commonly referred to as tranches. In certain circumstances, the existence of investments related to subprime loans may not be obvious and may be identified only upon performing audit procedures designed to identify such investments.

.64 Generally, entities report alternative investments at fair value and developing valuations, as well as obtaining sufficient appropriate audit evidence in support of the valuation assertion, can present challenges because of the lack of readily determinable fair value and the limited investment information generally provided by the fund managers. For example, the value of investments related to subprime loans (which may be either direct holdings of subprime loans or ownership of entities or investment vehicles, such as tranches, whose value is affected by the value of subprime loans) have declined significantly based on recent developments, including, but not limited to decreased liquidity for such investments. However, the existence of investments related to subprime loans within an alternative investment portfolio and the basis for their valuation may not be obvious.

.65 To address the auditing challenges associated with alternative investments, the Alternative Investments Task Force developed and issued a practice aid for auditors in 2006, titled "Alternative Investments—Audit Considerations." The practice aid clarifies the responsibility of the client to have appropriate controls in place in order for management to adequately address valuation assertions and for the auditor to obtain comfort over the valuation of investments. Specifically, the practice aid includes guidance on:

- General considerations pertaining to auditing alternative investments
- Addressing management's financial statement existence assertion
- Addressing management's financial statement valuation assertion
- Management representations
- Disclosure of certain significant risks and uncertainties
- Reporting

.66 The practice aid also includes appendices on confirmations for alternative investments and illustrative examples of due diligence, ongoing monitoring, and financial reporting controls. Many of the elements of the practice aid may assist auditors in addressing the audit issues related to recent subprime-related market developments. This practice aid may be downloaded at www.aicpa.org/members/div/auditstd/alternative_investments.htm.

.67 In addition, auditors should consider AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), to determine the appropriate period in which to recognize any identified declines in value. Given the timing of some of the declines in investments related to subprime loans, this may be particularly relevant for entities with June 30 year ends and may be a continuing consideration going forward.

Accounting Issues and Developments

.68 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions (FSPs) (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA Statement of Position (SOP) 07-1 (AICPA, *Technical Practice Aids*, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*
TIS section 6140.20–.22 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss not-for-profit organizations fund-raising expenses.
TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various employee benefit plan topics.
TIS sections 6300.25–.35 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various issues related to SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.69 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance 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. AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or go online at www.cpa2biz.com.

Fair Value Measurements

FASB Statement No. 157

.70 In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

.71 Prior to this statement, there were different definitions of fair value, and guidance for applying those definitions was dispersed among many accounting pronouncements. Differences in the existing guidance created inconsistencies that added to the complexity in applying generally accepted accounting principles (GAAP). FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period.

.72 The following paragraphs summarize FASB Statement No. 157, but are not intended as a substitute for the reading the statement itself. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.[2] Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year.

Definition of Fair Value

.73 Paragraph 5 of FASB Statement No. 157 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." That definition retains the exchange price notion in earlier definitions of fair value, but clarifies that the exchange price is the price in a hypothetical transaction at the measurement date in the market in which the reporting entity would transact for the asset or liability. The hypothetical transaction to sell the asset or transfer the liability is considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the definition of fair value focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

.74 A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market—defined as the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability—or, in the absence of a principal market, the most advantageous market for the asset or liability.

.75 A fair value measurement of an asset assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. Highest and best use for an asset is established by one of two valuation premises: value in-use or value in-exchange. The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, value in-use might be appropriate for certain nonfinancial assets. An asset's value in-use should be based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and

[2] FASB is considering a deferral of certain provisions of Statement No. 157. At the time of this writing no decision had been reached. See www.fasb.org for the latest developments.

that those other assets would be available to market participants. The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, value in-exchange might be appropriate for a financial asset. An asset's value in-exchange is determined based on the price that would be received in a current transaction to sell the asset standalone.

.76 A fair value measurement for a liability reflects its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value.

Valuation Techniques

.77 As described in FASB Statement No. 157, valuation techniques consistent with the market approach, income approach, cost approach or some combination of the approaches should be used to measure fair value, as follows:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.
- The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multi-period excess earnings method.
- The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

.78 Valuation techniques that are appropriate in the circumstances and for which sufficient data are available should be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate and the respective indications of fair value should be evaluated and weighted, as appropriate.

Present Value Techniques

.79 Appendix B of FASB Statement No. 157 provides guidance on present value techniques. Present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the discount rate adjustment technique (also called the traditional present value technique) uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, expected present value techniques use the probability-weighted average of all possible cash flows (referred to as expected cash flows). The traditional present value technique and two methods of expected present value techniques are discussed more fully in the Appendix B of FASB Statement No. 157.

The Fair Value Hierarchy

.80 FASB Statement No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability (referred to in the statement as inputs).

Paragraphs 21–31 establish a fair value hierarchy that distinguishes between (1) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (2) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs.

.81 The fair value hierarchy in FASB Statement No. 157 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The three levels are:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available, except as discussed in paragraphs 25–26 of FASB Statement No. 157.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall. Level 2 inputs include:
  - — Quoted prices for similar assets or liabilities in active markets
  - — Quoted prices for identical or similar assets or liabilities in markets that are not active
  - — Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)
  - — Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs)
- Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

Disclosures

.82 Paragraphs 32–35 of FASB Statement No. 157 expand the disclosures required for assets and liabilities measured at fair value. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition or that are measured on a nonrecurring basis in periods subsequent to initial recognition, the statement requires the reporting entity to disclose certain information that enables users of its financial statements to assess the inputs used to develop those measurements. For recurring fair value measurements using significant unobservable inputs (Level 3), the reporting entity is required to disclose certain information to help users assess the effect of the measurements on earnings (or changes in net assets) for the period.

FASB Statement No. 159

.83 Subsequent to the issuance of FASB Statement No. 157, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No.*

115. This statement is expected to expand the use of fair value measurement, which is consistent with the FASBs long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.84 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157. The choice to adopt early should be made within 120 days of the beginning of the fiscal year of adoption (by April 2007 for calendar-year-end entities), provided the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year of adoption. The FASB and SEC have expressed concern in the way some early adopters have applied the transition provisions of the standard. The AICPA Center for Audit Quality (CAQ) issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard such as this is applied in a good faith manner consistent with those objectives and principles. Specifically, the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans

.85 FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*, improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This statement also improves financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions.

.86 This statement requires an employer that is a business entity and sponsors one or more single-employer defined benefit plans to:

- Recognize the funded status of a benefit plan—measured as the difference between plan assets at fair value (with limited exceptions) and the benefit obligation—in its statement of financial position. For a pension plan, the benefit obligation is the projected benefit obligation; for any other postretirement benefit plan, such as a retiree health care plan, the benefit obligation is the accumulated postretirement benefit obligation.

- Recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to FASB Statements No. 87, *Employers' Accounting for Pensions*, or No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*. Amounts recognized in accumulated other comprehensive income, including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of FASB Statement Nos. 87 and 106, are adjusted as they are subsequently recognized as components of net periodic benefit cost, pursuant to the recognition and amortization provisions of those statements.

- Measure defined benefit plan assets and obligations as of the date of the employer's fiscal year-end statement of financial position (with limited exceptions).
- Disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation.

.87 This statement also applies to a not-for-profit organization or other entity that does not report other comprehensive income. Reporting requirements have been tailored for those entities.

.88 This statement amends FASB Statement No. 87; No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*; No. 106; No. 132 (revised 2003), *Employers Disclosures about Pensions and Other Postretirement Benefits—an amendment of FASB Statements No. 87, 88, and 106*; and other related accounting literature. Upon initial application of this statement and subsequently, an employer should continue to apply the provisions in FASB Statement Nos. 87, 88, and 106 in measuring plan assets and benefit obligations as of the date of its statement of financial position and in determining the amount of net periodic benefit cost.

.89 The FASB believes that this statement provides financial statements that are more complete and easier to understand because information previously reported in the notes will be recognized in an employer's financial statements. Reporting the current funded status of a postretirement benefit plan as an asset or liability in an employer's statement of financial position allows users of those financial statements to assess an employer's financial position and its ability to satisfy the benefit obligations without referring to a reconciliation in the notes to financial statements. Likewise, recognizing transactions and events that affect the funded status in the financial statements in the year in which they occur enhances the timeliness and, therefore, the usefulness of the financial information.

.90 The required date of adoption of the recognition and disclosure provisions of this statement differs for an employer that is an issuer of publicly traded equity securities (as defined) and an employer that is not. For purposes of this statement, an employer is deemed to have publicly traded equity securities if any of the following conditions is met:

a. The employer has issued equity securities that trade in a public market, which may be either a stock exchange (domestic or foreign) or an over-the-counter market, including securities quoted only locally or regionally.

b. The employer has made a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market.

c. The employer is controlled by an entity covered by (*a*) or (*b*).

.91 An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006.

.92 An employer without publicly traded equity securities is required to recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after June 15, 2007.

.93 However, an employer without publicly traded equity securities is required to disclose the following information in the notes to financial statements for a fiscal year ending after December 15, 2006, but before June 16, 2007, unless it has applied the recognition provisions of this statement in preparing those financial statements:

a. A brief description of the provisions of this statement

b. The date that adoption is required

c. The date the employer plans to adopt the recognition provisions of this statement, if earlier.

.94 The requirement to measure plan assets and benefit obligations as of the date of the employer's fiscal year-end statement of financial position is effective for fiscal years ending after December 15, 2008. If in the last quarter of the preceding fiscal year an employer enters into a transaction that results in a settlement or experiences an event that causes a curtailment of the plan, the related gain or loss pursuant to FASB Statement Nos. 88 or 106 is required to be recognized in earnings or changes in unrestricted net assets of that quarter.

.95 Earlier application of the recognition or measurement date provisions is encouraged; however, early application must be for all of an employer's benefit plans. Retrospective application of this statement is not permitted.

Income Tax Accruals and Deferred Income Taxes

FASB Interpretation No. 48

.96 FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109,* was issued in June 2006 and is effective for fiscal years beginning after December 15, 2006.[3] FIN 48 states that financial statement tax accrual may only contain positions that meet the *more-likely-than-not* standard and any variances must be disclosed in the financial statements. This translates to more work for accountants and auditors on the tax accrual, as you evaluate even garden-variety issues, such as unreasonable compensation or expensing versus capitalization. It also means that positions taken on the return (or that were taken in any open year) that do not meet the more-likely-than-not standard will be disclosed and will likely be subject to increased IRS scrutiny.

.97 The evaluation of a tax position in accordance with this interpretation is a two-step process. The first step is recognition: The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement: A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

.98 Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in FASB Statement No. 109, *Accounting for Income Taxes*, is not an appropriate substitute for the derecognition of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on the sufficiency of future taxable income is unchanged by this interpretation.

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[3] FASB is currently considering a one-year deferral of the effective date of this interpretation for nonissuers who have not already implemented FIN 48. See www.fasb.org for more information.

.99 For calendar-year corporations, the new rules would seem to initially take effect with first quarter 2007 results. However, the new rules require calendar-year corporations to have a "clean" starting point for their tax accounts at January 1, 2007. In other words, the deferred tax asset and deferred tax liability accounts on that date must be determined in accordance with the standards of FIN 48.

.100 A practice guide for accountants, auditors, and tax advisers has been posted to the AICPA's Tax Center at www.aicpa.org/tax under the Resources tab. An AICPA CPE course on accounting for income taxes that has been updated for FIN 48 is now available and an AICPA webcast also is being presented. Go to www.cpa2biz.com for more information on these products.

Additional Implementation Guidance for FIN 48

FASB Staff Position FIN 48-1

.101 In May 2007, the FASB issued FASB Staff Position (FSP) FSP FIN 48-1, *Definition of Settlement in FASB Interpretation No. 48*. The purpose of this FSP is to amend FIN 48 to clarify that a tax position could be effectively settled upon examination by a taxing authority. Assessing whether a tax position is effectively settled is a matter of judgment because examinations occur in a variety of ways. In determining whether a tax position is effectively settled, an enterprise should make the assessment on a position-by-position basis, but an enterprise could conclude that all positions in a particular tax year are effectively settled. The FSP describes conditions for evaluating effective settlement of a tax position, provides guidance for determining effective settlement with respect to examination of tax positions by taxing authorities, and provides a number of conforming changes to FIN 48 with respect to the new settlement terminology discussed in the FSP. The full text of the FSP can be found at www.fasb.org/fasb_staff_positions/fsp_fin48-1.pdf.

Independence and FIN 48

.102 In August 2007, the staff of the Professional Ethics Division issued nonauthoritative guidance (a frequently-asked-question, or FAQ) on the question of whether under Ethics Interpretation 101-3, "Performance of nonattest services," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05), members could assist an attest client in applying FIN 48 while maintaining independence. The staff of the Professional Ethics Division issued an FAQ that addresses whether independence is affected when a member helps an attest client apply FIN 48. The FAQ indicates that such services could be provided if the member met all of the requirements of Interpretation 101-3 and is satisfied that the client will be able to make informed judgments on the results of FIN 48 services (for example, understand why tax positions do or do not meet the more-likely-than-not threshold and the basis for any unrecognized tax benefit). In this way, the client may take responsibility for the amounts reported in the financial statements as a result of FIN 48.

.103 The FAQ was incorporated as question 23 into an existing FAQ document that is available on the Professional Ethics Divisions Web site at www.aicpa.org/download/ethics/nonattest_q_a.pdf.

SEC Regulations Committee Issues Revised Discussion Document on FIN 48

.104 On November 21, 2006, the SEC Regulations Committee issued a discussion document addressing specific questions regarding the implementation by public companies of FIN 48. Subsequently, the SEC staff has requested that the committee revise the discussion document to clarify the SEC staff's position regarding the financial statement presentation and disclosure when a registrant changes its accounting principle regarding the income statement classification of interest and penalties on uncertain income tax positions. Therefore, the committee amended the discussion document on February 6, 2007 to clarify the SEC staff's position, and is issuing a revised document that supersedes the previous *Appendix A—Disclosures under FASB Interpretation No. 48 in Form 10-Q in the Period of Adoption*, from the September 26, 2006 joint meeting between the SEC staff and the committee. The revised discussion document can be accessed at www.aicpa.org/caq/download/AppendixA_FIN48_092606_revised.pdf.

Recent AICPA Independence and Ethics Pronouncements

.105 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

On the Horizon

.106 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to auditors and accountants or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.107 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. 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 in addition to those discussed here. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+ Ethics+Code+of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Auditing Pipeline—Nonissuers

ASB Clarity Project

.108 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of GAAS. In March 2007, the ASB approved for exposure a discussion paper titled *Improving the Clarity of ASB Standards*. This discussion paper seeks feedback on proposed changes to the standards, including:

- Establishing objectives for each of the standards, and the auditor's obligations related to the objectives
- Structural and drafting improvements to make the standards easier to read and understand
- Inclusion, in the explanatory material of the standards, of special considerations related to audits of public entities and small entities
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards

.109 The period to comment ended June 15, 2007. The discussion paper can be accessed at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

Convergence With International Standards

.110 The ASB has created a number of task forces charged with monitoring specific activities of the IAASB and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of the ISA. Currently, the following ASB task forces exist:

- The Auditing Accounting Estimates Task Force is revising AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), with the objective of converging that section with the proposed, revised, and redrafted ISA No. 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.
- The Auditing Related Party Transactions Task Force plans to revise AU section 334, *Related Parties* (AICPA, *Professional Standards*, vol. 1), to achieve convergence with the related ISA, which the IAASB is developing.
- The Auditors' Reports Task Force is revising AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1). Simultaneously, the Auditor's Report Research Task Force is charged with performing research on the how the audit report might be revised to better address the existing expectation gap.
- The Going Concern Task Force is considering revisions to AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), based on proposed redrafted ISA No. 570, *Going Concern*. ISA No. 570 is predicated on International Accounting Standard (IAS) No. 1, *Presentation of Financial Statements*, which requires management to assess the entity's ability to continue as a going concern. While there is currently not a similar accounting requirement in U.S. GAAP, the FASB announced in May 2007 that it is adding a project to its agenda to address managements assessment of the entity's ability to continue as a going concern and the adoption of a liquidation basis of accounting.
- The Management Representations Task Force is considering revisions to AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1), to achieve harmonization with a proposed revision of ISA No. 580, *Written Representations*.

- The Service Organizations Task Force will develop a new attestation standard that provides guidance to service auditors performing service auditors' engagements. Currently AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1), provides guidance to both user auditors using service auditors' reports in an audit of financial statements and service auditors performing service auditors' engagements. When the new attestation standard is issued, AU section 324 will only contain guidance for user auditors. The task force will work to converge AU section 324 and the new attestation standard with ISA No. 402, *Audit Considerations Relating to an Entity Using a Service Organization*, and International Standard on Assurance Engagements (ISAE) No. 3402, *Assurance Reports on a Service Organization's Controls*, which the IAASB is currently developing.

- The Using the Work of a Specialist Task Force is revising AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), and replacing it with two new standards focusing on situations in which an auditor engages an outside (nonfirm) specialist to obtain the specialized skills or knowledge needed in the audit and situations in which an auditor uses as audit evidence the work product of a nonemployee specialist hired by management. The task force is monitoring the IAASB's progress to revise ISA No. 620, *Using the Work of an Expert*.

.111 The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.112 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1), the ASB decided to defer to issuance of a final revised AT section 501 until the PCAOB issued its amendments and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www.aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*

.113 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards titled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA, *Professional Standards*, vol. 1, AU sec. 411], as amended) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www.fasb.org. The ASB will issue its final SAS concurrently with the FASB and PCAOB's issuance of their final standards.

Auditing Pipeline—Issuers

PCAOB Proposed Rules and Standards

Proposed Ethics and Independence Rule 3526, Communication with Audit Committees Concerning Independence *and Proposed Amendment to Rule 3523,* Tax Services for Persons in Financial Reporting Oversight Roles

.114 On July 24, 2007, the PCAOB proposed an ethics and independence rule, Rule 3526, *Communication with Audit Committees Concerning Independence*, that would supersede the PCAOB's interim independence requirement, Independence Standards Board (ISB) Standard No. 1, *Independence Discussions with Audit Committees*, and two related interpretations (ISB Interpretation No. 00-1, *Independence Discussions with Audit Committees* and No. 00-2, *The Applicability of ISB Standard No. 1: When "Secondary Auditors" Are Involved in the Audit of a Registrant—An Amendment of Interpretation 00-1*). As part of the proposal, the PCAOB also proposed an amendment to Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles* (AICPA, *PCAOB Standards and Related Rules*), and further adjusted the implementation schedule for PCAOB Rule 3523.

Proposed Auditing Standard Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards

.115 On April 3, 2007, the PCAOB proposed changes to its auditing standards in light of the issuance of FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*, and the proposed FASB Statement, *The Hierarchy of Generally Accepted Accounting Principles*. This proposal, if adopted and approved by the SEC, would do the following:

- Supersede AU section 420, *Consistency of Application of Generally Accepted Accounting Principles* (AICPA, *PCAOB Standards and Related Rules*), with a new auditing standard
- Remove the GAAP hierarchy from the PCAOB's interim audit standards
- Make conforming amendments to the PCAOB's interim auditing standards

.116 For the full text of the proposal, see www.pcaob.org/Rules/Docket_023/2007-04-03_Release_No._2007-003.pdf.

.117 For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), mentioned previously.

Internal Control Pipeline

.118 COSO has released a discussion document titled, *Guidance on Monitoring Internal Control Systems.* Comments received will be used in developing an exposure draft, which is expected to be issued by the end of 2007 with final guidance scheduled to be released early in 2008.

.119 The purpose of this guidance, which is appropriate for entities of any size or structure, is to enhance the application and assessment of the monitoring component of COSO's *Internal Control—Integrated Framework*. While applicable to all organizations, this guidance would be especially useful to those with reporting requirements under U.S. Sarbanes-Oxley Act of 2002, Section 404. The discussion document as well as the current status of this project can be found at www.coso.org.

Accounting Pipeline

.120 Presented below are accounting projects and pronouncements currently in progress. Some of the proposed pronouncements discussed in the prior year's alert have not been finalized as of the date of this writing, and are included again.

Business Combinations

.121 Phase 1 of the business combination project resulted in the issuance of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*. In those statements, the FASB eliminated the use of the pooling of interests method of accounting for business combinations and addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. The objective of Phase 2 of this project is to standardize business combination accounting through the convergence of the FASB and International Accounting Standards Board (IASB) accounting standards and by reconsidering the existing guidance for the purchase method of accounting for business combinations. Among the main proposals are the following:

- All acquisitions of businesses should be measured at the fair value of the business acquired.
- Substantially all the assets acquired and liabilities assumed of the acquired business should be recognized and measured at their fair values at the acquisition date.
- Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.122 In June 2005, the FASB and IASB issued a number of exposure drafts, for which comment periods ended in October 2005. Redeliberations began in January 2006 and were completed in June 2007. The FASB and IASB expect to issue final statements during the fourth quarter of 2007. Four standards are expected to be issued:

- Proposed FASB Statement No. 141(R) and International Financial Reporting Standard (IFRS) No. 3(R), *Business Combinations*
- Proposed FASB Statement No. 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*
- Proposed IAS Statement No. 27(R)

Readers should remain alert to the final issuances and visit the FASB Web site for further information.

Fair Value

.123 During Phase 1 of the FASB's fair value option project, the FASB issued FASB Statement No. 159, which was previously discussed. In Phase 2 of the project, the FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on Phase 2 are expected to begin in the third quarter of 2007. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.124 In December 2006, the FASB issued an exposure draft titled, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure ended in March 2007, and the FASB has begun redeliberations to consider significant issues raised by respondents. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133, including how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entitys financial position, results of operations, and cash flows. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.125 The FASB is working on a project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, to address issues related to the permitted activities of a qualifying special-purpose entity (QSPE), isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, the FASB issued an exposure draft, titled *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During 2007, the FASB expects to address issues related to the permitted activities of a QSPE and then issue another exposure draft during the fourth quarter of 2007 containing potential amendments to FASB Statement No. 140. See the FASB Web site for complete information.

Earnings Per Share

.126 The FASB and IASB have been working together to resolve differences between FASB Statement No. 128, *Earnings per Share*, and IAS Statement No. 33, *Earnings per Share*. This project is part of the larger FASB project, Short-term International Convergence, which has resulted in the issuance of a number of FASB statements. Currently the FASB and IASB are addressing significant differences that remain relating to instruments that can be settled in cash or shares and are classified as a liability on an entity's balance sheet. The FASB and IASB are considering modifications to the treasury stock method and several scoping issues in which either the FASB or IASB has issued or may issue more detailed implementation guidance on earnings per share that may create a convergence difference. The FASB and IASB are expected to issue an exposure draft for public comment during the third quarter of 2007. This exposure draft will be the third exposure draft the FASB has issued on the earnings per share project. The project and current exposure draft can be reviewed on the FASB Web site.

FASB Codification and Retrieval Project

.127 The goal of this FASB project is to create a single, authoritative codification of U.S. GAAP. The codification will integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, Emerging Issues Task Force (EITF), and the SEC). The codification will have a three layered structure: topic, subtopic, and section. The FASB has structured the topics into three primary areas: overall presentation, transactional (or financial statement account), and industry. The overall presentation area addresses presentation of financial information but does not address items such as recognition, measurement, or derecognition. The transactional or financial statement account area addresses accounting recognition, measurement, or derecognition. The industry area includes guidance unique to the industry. A codification draft is expected in 2007 and will have an extended verification period to ensure that it accurately reflects U.S. GAAP. Once the FASB addresses respondent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards. Readers can track progress of the Codification and Retrieval Project on the FASB Web site at www.fasb.org/project/codification&retrieval_project.shtml.

Convergence With International Financial Reporting Standards

.128 Since their joint meeting in September 2002, the FASB and IASB have had a common goal—one set of accounting standards for international use. At that time, The Norwalk Agreement, a memorandum of understanding between the two rule-setting bodies, was signed. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. At that meeting, the FASB and the IASB pledged to use their best efforts to make their existing financial reporting standards fully compatible as soon as is practicable and to coordinate their future work programs to ensure that once achieved, compatibility is maintained. At their meetings in April and October 2005, the FASB and IASB reaffirmed their commitment to the convergence of U.S. GAAP and IFRS. A common set of high quality global standards remains the long-term strategic priority of both the FASB and the IASB.

.129 There has been progress towards this goal. FASB Standard Nos. 157 and 159 take U.S. GAAP in the direction of IFRS with respect to reporting at fair value. Also, in June 2007, the SEC announced that it was issuing for public comment a proposed rule that would eliminate the requirement to provide a reconciliation of IFRS-based financial statements to U.S. GAAP-based financial statements for foreign private issuers that file reports with the SEC.

.130 The goal of the FASB and the IASB is to reach a conclusion by 2008 about whether major differences in the a few focused areas should be eliminated through one or more short-term standard-setting projects and, if so, complete or substantially complete work in those areas. Those areas include impairment, income taxes, investment properties, government grants, research and development, joint ventures, subsequent events, and segment reporting. For more information on the status of this project go to www.fasb.org and www.iasb.org.

Private Company Financial Reporting

.131 The FASB and the AICPA are committed to exploring ways to enhance the value, transparency, and cost effectiveness of financial reporting for private companies. As a result, these two organizations have created a new committee, the Private Company Financial Reporting (PCFR) committee, whose primary objective will be to provide recommendations to the FASB as the FASB sets accounting standards for privately held enterprises.

.132 The PCFR has issued a proposal that recommends making certain improvements to the FASB's current processes for determining whether differences are needed in prospective and existing accounting standards for private company financial reporting and sponsoring a committee designed to increase private company constituent input in the standard-setting process. In assessing the need for differences for private companies in recognition, measurement, disclosure, and presentation, the FASB will consider the needs of users of financial statements as well as cost-benefit considerations. The full text of this proposal and additional information on this project is available at www.pcfr.org.

GAAP Hierarchy

.133 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, that is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonissuers" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.134 ***Proposed FASB EITF Issues.*** Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.135 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/project/potential_fspd&other.shtml for complete information.

Resource Central

.136 The following are various resources that practitioners may find beneficial.

Publications

.137 Practitioners may find the following publications useful with respect to recent accounting and auditing developments:

- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2007) (product no. 012517kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2007) (product no. 012777kk)
- Audit Risk Alert *Compilation and Review Alert—2007/08* (product no. 022308kk)
- Audit Risk Alert *Independence and Ethics Alert—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Checklist and Illustrative Financial Statements for Corporations* (product no. 008938kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.138 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firms needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, TPAs, 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.

Continuing Professional Education

.139 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191 [DVD]). 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.
- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

.140 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.141 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPAs flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics.

.142 To register or learn more, visit www.cpa2biz.com.

Webcasts

.143 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high quality, two-hour CPE programs that bring you the latest topics from the professions leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.144 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFOs personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.145 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the professions leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.146 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.147 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. You can reach the Technical Hotline at (877) 242-7212.

Ethics Hotline

.148 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.

AICPA Governmental Audit Quality Center

.149 The Governmental Audit Quality Center (GAQC) is a firm-based voluntary membership Center designed to help CPAs meet the challenges of performing quality audits in this unique and complex area. The GAQC's primary purpose is to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The GAQC also offers resources to enhance the quality of a firm's governmental audits.

.150 The mission of the GAQC is to do the following:

- Raise awareness about the importance of governmental audits.
- Serve as a comprehensive resource provider on governmental audits for member firms.
- Create a community of firms that demonstrates a commitment to governmental audit quality.
- Provide center members with an online forum tool for sharing best practices and discussing audit, accounting, and regulatory issues.
- List member firms to enable purchasers of governmental audit services to identify firms that are members.
- Provide information about the center's activities to other governmental audit stakeholders.

.151 For more information about the GAQC, visit http://gaqc.aicpa.org.

AICPA Center for Audit Quality

.152 The CAQ (formerly the Center for Public Company Audit Firms) was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.153 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQis a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

AICPA Employee Benefit Plan Audit Quality Center

.154 The Center is a voluntary membership organization for firms that perform or are interested in performing Employee Retirement Income Security Act (ERISA) employee benefit plan audits. The Center was established to promote the quality of employee benefit plan audits.

.155 To achieve this goal, the Center has created a community of firms that demonstrate a commitment to employee benefit audit quality, and supports those firms by:

- Providing members with timely communication of regulatory developments, best practices guidance, and technical updates
- Providing members with an online community forum for sharing best practices as well as discussions on audit, accounting, and regulatory issues
- Maintaining relationships with, and acting as a liaison to, the DOL on behalf of member firms
- Providing Center members with a marketing toolkit to facilitate promotion of their membership in the Center
- Providing information about the Centers activities to other employee benefit plan stakeholders

.156 The increasing complexity of employee benefit plan auditing and increased scrutiny by the DOL have resulted in a significant number of changes and issues for auditing firms and CPAs in general. Firms and CPAs will benefit from the assistance of the Center as a resource for improving employee benefit plan audit quality.

.157 For more information about the Employee Benefit Plan Audit Quality Center, visit ebpaqc.aicpa.org.

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.158 This Audit Risk Alert replaces General *Audit Risk Alert—2006/07*.

.159 The General *Audit Risk Alert* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next years 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 appreciated. You may e-mail these comments to ccole@aicpa.org or write to:

Christopher Cole, CPA, CFE
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

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Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/ Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/ Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org

(continued)

Web Site Name	*Content*	*Web Site*
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov

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AAM Section 8015

Compilation and Review Alert—2007/08

CURRENT ACCOUNTING
REPORTING AND PRACTICE ISSUES

NOTICE TO READERS
COMPILATION AND REVIEW ALERT—2007/08

This *Compilation and Review Alert* is intended to provide accountants with an update on recent practice issues and professional standards that affect compilation and review engagements.

This publication is an *other compilation and review publication* as defined in AR section 50, *Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2). Other compilation and review publications have no authoritative status; however, they may help the accountant understand and apply the Statements on Standards for Accounting and Review Services.

If an accountant applies the guidance included in an other compilation and review publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the engagement and appropriate. The 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 upon by any senior technical committee of the AICPA.

Written by Kristy L. Illuzzi, CPA
Technical Manager
Accounting and Auditing Publications

Acknowledgments

The Accounting and Auditing Publications Team would like to thank the members of the Accounting and Review Services Committee for their invaluable review of this year's publication. In addition, we would like to thank the following individuals for their contributions to this year's publication:

Michael Glynn, Technical Manager, AICPA Audit and Attest Standards

Sue Lieberum, Senior Technical Manager, AICPA Peer Review Program

How This Alert Helps You

.01 This *Compilation and Review Alert* (alert) is a crucial tool, designed to help you as you plan and perform your compilation and review engagements. This alert discusses recent Standards for Accounting and Review Services (SSARS) developments, addresses emerging practice issues, points out pitfalls that frequently occur in compilation and review engagements, and provides valuable current accounting developments.

.02 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, SSARS No. 1, *Compilation and Review of Financial Statements*, would be referred to as AR section 100 of the AICPA *Professional Standards*.

Economic Developments

The State of the Economy

.03 When compiling or reviewing financial statements, you should possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates that will enable you to compile or review the financial statements for an entity operating in that industry. Furthermore, to compile or review financial statements, you should possess a general understanding of the nature of the entity's business transactions. As part of this knowledge and understanding, you may obtain an understanding of the economic conditions facing the industry in which your client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on your client.

.04 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, GDP increased at an annual rate of 2.9 percent in 2006, consistent with the pace of growth experienced in 2005 when GDP increased by 3.1 percent. During the first quarter of 2007, GDP increased by an annual rate of only 0.6 percent. However, according to second quarter preliminary estimates, GDP increased at an annual rate of 4.0 percent.

.05 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, with an annual average rate of 4.6 percent representing approximately 7 million people. The 2006 rates represent the lowest annual rate and total number of jobless since 2000, according to the U.S. Department of Labor, Bureau of Labor Statistics. During the first half of 2007, the unemployment rate averaged 4.5 percent. These data further demonstrate the economic growth the United States has experienced since the beginning of 2006.

.06 After a period of rising rates during the first half of 2006, the Federal Reserve kept its target for the federal funds rate at 5.25 percent for 10 consecutive meetings (June 2006–August 2007). At that time, the Federal Reserve indicated future federal fund rate adjustments would likely depend upon the outlook for economic growth and inflation. Since its August 2007 meeting and in response to shaky financial market conditions, the Federal Reserve has taken several action steps. It announced that it would provide reserves as necessary through the open market to facilitate the orderly functioning of financial markets by promoting trading in the federal funds market at rates close to the 5.25 percent target rate. On August 17, 2007, it announced that financial market conditions had deteriorated and tighter credit conditions and increased uncertainty have the potential to restrain economic growth. Then, at its September meeting, the Federal Reserve decided to lower its target for the federal funds rate 50 basis points to 4.75 percent citing increased uncertainty surrounding the economic outlook. The Federal Reserve also decided to decrease the discount rate 50 basis points to 5.25 percent to consistently keep the spread between the primary credit rate and the target federal funds rate at 50 basis points. Accountants should remain alert to developments in the financial markets and how they may affect your compilation and review engagements.

Small Business Trends and Conditions

.07 Private companies, and more specifically, small businesses, are a main driver for the United States economy. According to the National Federation of Independent Businesses, small business produces roughly half of the private gross domestic product and between 60 percent and 80 percent of net new jobs. The United States has almost 6 million small business employers, 90 percent of which employ fewer than 20 people. Small firms represent 99.7 percent of all employers, and small firms with fewer than 500 employees represent 99.9 percent of the 26.8 million businesses in the country, both large and small.

.08 In August 2007, Discover Business Card released the results of the *Discover Small Business Watch*, a monthly index of economic confidence of the nation's 22 million small businesses with five or fewer employees. The *Discover Small Business Watch* (Watch) is based upon a nationally random survey of 1,000 small business owners and 4,000 potential users of small business products and services. The survey data is compiled by Rasmussen Reports, a leading independent public opinion polling company.

.09 Economic confidence among small business owners fell in August 2007 as small business owners expressed less confidence in the economic conditions for their business and experienced more cash flow issues. The Watch is down nearly five points over July 2007 and is nearly level with the Watch's lowest index since inception in August 2006.

.10 Among the key findings, the survey found that 36 percent of small business owners feel that economic conditions for their business are getting better, a significant decrease from 41 percent in July 2007. In addition, 41 percent said they have experienced cash flow issues in the last 90 days, an increase over July's 35 percent.

.11 One of the main reasons for the declines relates to the housing market slump and related economic impact. More than one in three business owners said recent changes in the housing market have had a significant impact on their business. In addition, more than one third of business owners also noted that if obtaining credit becomes more difficult, it will have an impact on their business. When asked what kind of effect the recent changes in the housing market have had on their personal budgets and financial decisions, more than one in three small business owners said the impact was significant. On the bright side, the poll also found that 42 percent of consumers said they expected houses in their area to be priced higher six months from now, which could help soften the impact on small business owners.

.12 Overall, the economic outlook remains uncertain. You should pay close attention to how economic factors such as interest rates, consumer confidence, the housing market, overall economic expansion or contraction, inflation, and the labor market will affect your clients and your compilation and review engagements this year.

Current SSARS Developments

Issuance of SSARS No. 15

.13 On July 24, 2007, the Accounting and Review Services Committee (ARSC) issued SSARS No. 15, *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2).

.14 In many instances, the SSARSs would refer the practitioner to Statements on Auditing Standards (SASs). However, for many practitioners, compilations and reviews represent the highest level of service performed, and therefore, those practitioners may be unfamiliar with the auditing literature. The ARSC determined that it would be in the best interest of practitioners performing compilations and reviews as well as in the public interest if certain references to the auditing literature were eliminated from the SSARSs. To accomplish this, the ARSC issued SSARS No. 15, which eliminates those references to auditing literature from the SSARSs and provides guidance similar to that originally referenced.

.15 SSARS No. 15 amends AR section 100, *Compilation and Review of Financial Statements*; AR section 200, *Reporting on Comparative Financial Statements*; AR section 300, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms*; and AR section 400, *Communications Between Predecessor and Successor Accountants*, all of which are found in AICPA, *Professional Standards*, vol. 2. This SSARS provides new or enhanced guidance by:

- Providing a definition of "other comprehensive basis of accounting" (OCBOA)
- Providing examples of appropriate OCBOA financial statement titles
- Providing reporting examples for compilations and reviews of OCBOA financial statements
- Providing guidance related to an emphasis of a matter when reporting on complied or reviewed financial statements
- Clarifying the accountant's responsibility with respect to facts discovered subsequent to the date of the accountant's compilation or review report
- Providing additional illustrative representations that may be appropriate for inclusion in the management representation letter
- Providing a new appendix, Appendix J, entitled "Sources of Generally Accepted Accounting Principles"

.16 In addition, because the appropriate guidance is now included in AR section 100, the following interpretations have been withdrawn by the issuance of SSARS No. 15:

- Interpretation No. 4, "Discovery of Information After the Date of the Accountant's Report" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.13–.15), which interpreted AR section 100, *Compilation and Review of Financial Statements* was rescinded.
- Interpretation No. 12, "Reporting on a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.41–.45), which interpreted AR section 100 was rescinded.

.17 SSARS No. 15 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2007, with earlier application permitted.

SSARS Exposure Draft, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services*

.18 In December 2005, the Auditing Standards Board (ASB) issued SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1). SAS No. 102 expressly defined imperatives used to describe different degrees of the auditor's responsibility when conducting audit engagements in accordance with generally accepted auditing standards. The ARSC has concluded that by defining the levels of responsibilities that accountants have in compilation and review engagements in a fashion similar to SAS No. 102, standards for compilation and review engagements will be clarified, and the imperatives used in such standards will be consistent with the standards for audit engagements. The ARSC further concluded that this clarity and consistency will assist accountants in their work and improve the quality of compilation and review engagements.

.19 The proposed SSARS defines two categories of professional requirements:

- *Unconditional Requirements*. The accountant is required to comply with a requirement in all cases in which the circumstances exist to which the requirement applies. A requirement is indicated by the words "must" or "is required."
- *Presumptive Requirements*. The accountant is also required to comply with a presumptive requirement in all cases in which the circumstances exist to which the presumptive requirement applies. The accountant may depart from a presumptive requirement provided that he or she documents the

justification for departure and how alternative procedure(s) performed in the circumstances were sufficient to achieve the objectives of the presumptive requirement. The word "should" indicates a presumptive requirement.

.20 SSARSs also contain explanatory material that is intended to provide further explanation and guidance on the professional requirements. Such explanatory material is intended to be descriptive rather than imperative. All professional requirements that a SSARS imposes on the accountant will be identifiable by the use of "must," "is required," or "should" statements.

.21 This exposure draft was issued in August 2007, and the exposure period ends on October 25, 2007. The proposed SSARS, which is expected to be issued as SSARS No. 16 in the fourth quarter of 2007, will be effective upon issuance.

SSARS Exposure Draft, *Omnibus Statement on Standards for Accounting and Review Services—2008*

.22 In October 2007, the ARSC issued an exposure draft (ED) of a proposed Omnibus SSARS that, if issued as a final SSARS, would:

- Replace the term *nonpublic entity* in the SSARSs literature with the term *nonissuer*. This would conform the terminology in the SSARSs to the terminology used by other standards setters.
- Clarify the objectives and limitations of compilation and review engagements.
- Make clear that the accountant must, at a minimum, apply analytical procedures to the financial statements, make inquiries of management and, when deemed appropriate, other company personnel and obtain representations from management for all financial statements and periods covered by the accountant's report when performing a review engagement.
- Introduce a definition of "management" and revise the definition of "third parties" to clarify that the phrase "who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of financial statements" applies to "members of management."
- Revise SSARSs to state that management's written representations should be made as of the date of the accountant's review report.
- Provide guidance on the accountant's consideration of subsequent events in a compilation or review engagement.
- Provide guidance on the accountant's consideration, in a compilation or review engagement, of an entity's ability to continue as a going concern.

.23 In addition, the ED states:

> "The accountant need not be in physical receipt of the management representation letter as of the date of the accountant's review report provided management has acknowledged that they will sign the representation letter, without exception."

.24 The Omnibus ED also proposes to add an exhibit on analytical procedures in a review engagement, as members have expressed a great deal of interest in the analytical procedures in the AICPA Issues Paper, *Analytical Procedures in a Review Engagement*. The issues paper was issued after the issuance of SSARS No. 10, *Performance of Review Engagements* (AICPA, *Professional Standards*, vol. 2), to provide additional guidance to accountants. The ED incorporates the guidance from that issues paper and expands upon such guidance. The comment period ends on December 28, 2007. The ARSC expects to issue the proposed SSARS as SSARS No. 17 in January 2008.

Recently Issued Compilation and Review Interpretations of the SSARS

.25 Compilation and review interpretations of the SSARSs are interpretive publications pursuant to AR section 50, *Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2). Interpretive publications are not standards for accounting and review services. Interpretative publications are recommendations on the application of SSARSs in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued after all ARSC members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SSARSs.

.26 The accountant should be aware of and consider interpretive publications applicable to his or her compilation or review. If the accountant does not apply the guidance included in an applicable interpretive publication, the accountant should be prepared to explain how he or she complied with the SSARSs provisions addressed by such guidance.

Interpretation No. 28—Special-Purpose Financial Statements

.27 In December 2006, a new interpretation of AR section 100 was added, Interpretation No. 28, "Special-Purpose Financial Statements to Comply With Contractual Agreements or Regulatory Provisions" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.109–.119), which addresses special-purpose financial statements to comply with contractual agreements or regulatory provisions. When asked to prepare such financial statements, the basis of accounting prescribed in the agreements or provisions may result in an incomplete presentation, but one that is otherwise in conformity with generally accepted accounting principles (GAAP) or OCBOA. When the accountant submits compiled or reviewed special-purpose financial statements prepared on a basis of accounting prescribed in a contractual agreement or regulatory provision that results in an incomplete presentation, but one that is otherwise prepared in conformity with GAAP or OCBOA, the accountant's report should be modified to include an explanatory paragraph with the following information:

- An explanation of what the financial statement is intended to present and a reference to the note to the special-purpose financial statement that describes the basis of presentation
- If the basis of presentation is in conformity with GAAP or OCBOA, a statement that the presentation is not intended to be a complete presentation of the entity's assets, liabilities, revenues, and expenses
- A separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity, the parties to the contract or agreement, the regulatory agency with which the report is being filed, or those with whom the entity is negotiating directly, and is not intended to be and should not be used by anyone other than these specified parties

.28 A second scenario that could result when asked to prepare financial statements in accordance with a contractual agreement or regulatory provision would be a presentation that is not in conformity with GAAP or OCBOA. When the accountant submits compiled or reviewed special-purpose financial statements prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with GAAP or OCBOA, the accountant's report should be modified to include an explanatory paragraph with the following information:

- An explanation of what the presentation is intended to present and a reference to the note to the special-purpose financial statements that describes the basis of presentation
- A statement that the financial statement is not intended to be a presentation in conformity with GAAP or an OCBOA

- A description and the source of significant interpretations, if any, made by the company's management relating to the provisions of a relevant agreement
- A separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity, the parties to the contract or agreement, the regulatory agency with which the report is being filed, or those with whom the entity is negotiating directly, and is not intended to be and should not be used by anyone other than these specified parties. For example, if the financial statements have been prepared for the specified purpose of obtaining bank financing, the report's use should be restricted to the various banks with which the entity is negotiating the proposed financing.

.29 This interpretation also gives illustrative examples of both a compilation and review report for such circumstances.

Interpretation No. 29—Dealing With Uncertainties

.30 In February 2007, Interpretation No. 29, "Reporting on an Uncertainty, Including an Uncertainty About an Entity's Ability to Continue as a Going Concern" (AICPA, *Professional Standards*, vol. 2, AR sec. 9100.120–.129), was issued, which addresses reporting during a compilation or review engagement an uncertainty, including an uncertainty about an entity's ability to continue as a going concern. Continuation of an entity as a going concern is assumed in financial reporting in the absence of significant information to the contrary. If, during the performance of compilation or review procedures, evidence or information comes to the accountant's attention that there may be an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being compiled or reviewed, the accountant should consider the adequacy of management's disclosure of the uncertainty.

.31 This interpretation provides examples of emphasis of the going concern in the compilation or review report. In addition, it addresses dealing with uncertainties other than a going concern, which may include uncertainties regarding legal judgments.

ARSC's Consideration of Independence in a Compilation Engagement

.32 As a result of the evolving complexity of the Independence Standards as codified in the AICPA *Code of Professional Conduct*, the ARSC issued a Discussion Memorandum/Survey in October 2005 to obtain the input of CPAs, their clients, and third-party users of compiled financial statements as to the need for independence when performing compilation engagements. During the seven months that the Discussion Memorandum/Survey was available, the ARSC received over 4,300 responses. After holding a public meeting in May 2006 to discuss the results of the survey, the ARSC had determined that more information was needed as to what the users of compiled financial statements would want to see in compilation reports.

.33 The ARSC reached out to the American Bankers Association (ABA) and the Risk Management Association (RMA) to facilitate a meeting. On September 24, 2007, the ARSC met with representatives of the ABA and the RMA to discuss their groups concerns regarding independence in compilation engagements, as they represent third-party users of compiled financial statements.

.34 More specifically, topics discussed at the meeting included the following:

- Eighty-eight percent of third party users responded to the survey that they wanted to know the reasons for independence impairments, what specifically would they want third parties to know, and what would be the most useful presentation for third party users.

- Whether third party users feel that compiled or reviewed financial statements are more reliable if the accountant performs certain nonattest functions, even if performance impairs the accountant's independence.
- Whether the standard compilation and review reports should be modified to make them more useful to third party users.

.35 In conjunction with the ABA and RMA representatives, it was determined that additional information was needed from third-party users of compiled financial statements prior to developing any proposals to revise the reporting requirements for compilation engagements. During the fourth quarter of 2007, the ARSC will work with the ABA and RMA to develop certain additional questions and to facilitate acquiring the necessary information. The ARSC will continue to keep the membership informed as the process continues.

Current Practice Issues

AICPA Guidance for Bookkeeping Engagements

.36 The ARSC is assisting in the development of an AICPA Practice Aid for bookkeeping engagements. The practice aid, when issued, will focus on how existing standards apply to bookkeeping engagements, specifically Quality Control Standards, including client acceptance and continuance procedures and communication of best practices. In addition, the practice aid should address certain practical situations, such as whether a compilation report is necessary if financial statements are prepared, as well as issues regarding accountant independence. This practice aid is expected to be issued in 2008.

Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control*

.37 In September 2005, a task force was formed to review the Statements on Quality Control Standards (SQCS) and determine if and how they should be amended, in light of the changes in the quality control environment in the past two years, and with the goal of convergence with International Statement of Quality Control Standard No. 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*. The task force comprises members from the ASB, the ARSC, the Peer Review Board, and the Center for Public Company Audit Firms Peer Review Committee.

.38 On October 10, 2007, SQCS No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, vol. 2), was issued. This new SQCS supersedes existing statements on quality control standards and differs from them as follows:

- Defines the term *engagement quality control review*, and requires firms to establish which engagements are to be subject to an engagement quality control review.
- Defines the terminology the ASB uses to describe the degrees of responsibility that the requirements in SQCSs impose on firms, which includes use of the terms *unconditional requirements* and *presumptively mandatory requirements*.
- Requires a firm to document its quality control policies and procedures. The extent of the documentation is based on the size, structure, and nature of the firm's practice.
- Requires a firm's system of quality control to address each of the following elements: leadership responsibilities for quality within the firm, relevant ethical requirements, acceptance and continuance of client relationships, human resources, engagement performance, and monitoring.

- Recognizes the importance of a quality-oriented internal culture and requires firms to (*a*) establish policies that require the firm to assign its management responsibilities so that commercial considerations do not override the quality of work performed, and (*b*) address personnel performance evaluation, compensation, and advancement to demonstrate the firm's overarching commitment to quality.
- Provides more detailed guidance on independence and requires a written confirmation of compliance with independence requirements from all firm personnel at least annually.
- Provides more detailed guidance on client acceptance and continuance, and requires documentation of the resolution of significant issues.
- Provides more detailed guidance on engagement supervision and review, engagement documentation, and consultation policies and procedures.
- Requires policies and procedures for resolving differences of opinions, including a requirement that reports must not be released until all differences of opinions are resolved.
- Requires performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and regulatory requirements, and the firm's quality control policies and procedures.
- Requires policies and procedures for dealing appropriately with complaints and allegations of noncompliance with professional standards or with the firm's system of quality control.

.39 This SQCS is effective as of January 1, 2009.

Common Peer Review Findings

.40 In 2006, the AICPA Peer Review Program reported approximately 10,100 peer reviews, of which approximately 5,100 pertained to compilation and review engagements. The importance of the peer review findings cannot be overemphasized. The following is a summary of some of the most recent significant deficiencies that an accountant should keep in mind when planning and staffing compilation and review engagements.

Reports, Financial Statement Measurement, Presentation, and Disclosure

.41 The following is a list of some deficiencies that were encountered with regards to financial reporting:

Deficiency	*Practical Example*
Departures from standard wording where the report does not contain the critical elements of the applicable standards	It is not uncommon to see compilation and review reports with no reference to the SSARSs in those reports.
Issuance of a review report when the accountant is not independent with respect to the client	Although an accountant may report on compiled financial statements if he or she is not independent (by modifying the compilation report), the accountant may not issue a review report if he or she is not independent. In all cases in which the CPA issues an "assurance" report (audit or review) on the financial statements, the CPA must be independent with respect to the client in order to perform the engagement (that is, modifying the review report for a lack of independence is inappropriate).

(continued)

Failure to disclose lack of independence in a compilation report	Although an accountant may report on compiled financial statements when he or she is not independent, the SSARSs require modification of the compilation report to clearly indicate this lack of independence by adding a one-sentence paragraph to the compilation report, specifically, "I am [We are] not independent with respect to XYZ Company."
Failure to disclose the omission of substantially all disclosures	A CPA may compile financial statements with disclosures omitted as long as the omission of disclosures is clearly indicated in the compilation report, and the disclosures are not omitted with the intent to "mislead" those who might reasonably be expected to use the financial statements. A third paragraph should be added to the compilation report as follows: Management has elected to omit substantially all 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.
Failure to disclose the omission of the statement of cash flows in financial statements prepared in accordance with GAAP	Pursuant to the guidance in FASB Statement No. 95, *Statement of Cash Flows*, if financial statements include both a balance sheet and an income statement, the statement of cash flows should be provided for each period that the income statement is provided. Given this fact, the statement of cash flows needs to be provided when the CPA reviews financial statements (or the failure to include the statement of cash flows should be disclosed as a departure from GAAP in the accountant's review report); the same issue or result would exist when the CPA compiles full-disclosure financial statements. However, if the CPA compiles financial statements in which management elects to omit substantially all disclosures, the omitted statement of cash flows can be "referenced" in the paragraph that reports the fact that disclosures have been omitted, as follows: Management has elected to omit substantially all the disclosures and the statement of cash flows required by generally accepted accounting principles. If the omitted disclosures and statement were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

Significant departures from the financial statement formats prescribed by industry accounting and audit guides	In many cases, this deficiency is prevalent if CPAs are preparing and reporting on financial statements of clients in "special industries" in which they try to "fit" the standard financial statement formats for use in these industries. For example, for health care clients, there is a requirement for a "performance indicator" to be included in the financial statements. As another example, not-for-profit organizations have a statement of activities (rather than an income statement) in which all changes in net assets during a reporting period are reflected in that statement. If CPAs try to utilize formats that are applicable to the "normal" business entities, it is not uncommon for some of the special industry guidance not to be followed. You should refer to the appropriate AICPA audit and accounting guides when financial statements are being compiled or reviewed.
Omission of disclosures of significant accounting policies applied (GAAP or OCBOA)	As a result of significant changes in disclosure requirements in recent years, CPAs need to be careful not to "copy last-year" disclosures in current-year financial statements. Some of the required policy note disclosures are often easily missed. Commonly missed policy note disclosures include the nature of operations, use of estimates, advertising costs, shipping and handling costs, basis of accounting for receivables (and the bad debts associated with those receivables). All significant accounting policies should be included in GAAP and OCBOA financial statements.
Misclassification of a material transaction or balance	You should make sure that items, transactions, and events are classified appropriately in the financial statements.
Omission of significant required disclosures related to material financial statement balances or transactions	Always use a current disclosure checklist applicable to the basis of accounting used.
Omission of significant matters related to the understanding of the financial statements (the cumulative material effect of a number of deficiencies)	This deficiency occurs if several minor deficiencies result in a cumulative material effect on the financial statements when viewed in the aggregate.

SSARS Procedures and Documentation

.42 Below are some deficiencies that were noted in regards to specific SSARS procedures and related documentation:

Deficiency	*Practical Example*
Failure to document the matters covered in the accountant's inquiries and analytical procedures in review engagements	Inquiries and analytical procedures provide the basis for the limited assurance expressed in the review report, and must be documented. AR section 100 contains a list of required documentation for a review engagement, including the requirement to document significant expectations.

(continued)

Failure to obtain a proper client management representation letter for a review engagement	A management representation letter is required in all review engagements. This letter should be updated to include all current information and cover all periods presented in the financial statements. These letters are not required in compilation engagements.

.43 Although there are many recurring deficiencies noted in peer review, the accountant can take steps to avoid them by keeping these common mistakes in mind during the planning and performance of future compilation and review engagements.

Recent AICPA Independence and Ethics Pronouncements

.44 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.45 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions (FSPs) (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA Statement of Position (SOP) 07-1 (AICPA, *Technical Practice Aids*, vol. 2, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*

AICPA TPA TIS section 6140.20–.22 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	This question and answer discusses not-for-profit organizations fund-raising expenses.
AICPA TPA TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	This question and answer discusses various employee benefit plan topics.
AICPA TPA TIS section 6300.25–.35 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	This question and answer discusses various issues related to SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.46 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to compilation and review engagements 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, call (888) 777-7077 or go online at www.cpa2biz.com.

Fair Value Measurements

FASB Statement No. 157

.47 In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

.48 Prior to this statement, there were different definitions of fair value, and guidance for applying those definitions was dispersed among many accounting pronouncements. Difference in the existing guidance created inconsistencies that added to the complexity in applying GAAP. FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. Readers can access the full text of FASB Statement No. 157 on the FASB Web site at www.fasb.org.

FASB Statement No. 159

.49 Subsequent to the issuance of FASB Statement No. 157, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with the

FASB's long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement Nos. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.50 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157. The choice to adopt early should be made within 120 days of the beginning of the fiscal year of adoption (for calendar year end entities, by April 2007), provided the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year of adoption. The FASB and Securities and Exchange Commission (SEC) have expressed concern in the way some early adopters have applied the transition provisions of the standard. The AICPA Center for Audit Quality (CAQ) issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard such as this is applied in a good faith manner consistent with those objectives and principles. Specifically the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*

.51 This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

.52 The evaluation of a tax position in accordance with this interpretation is a two-step process. The first step is recognition: The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement: A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

.53 Differences between tax positions taken in a tax return and amounts recognized in the financial statements will generally result in one of the following:

1. An increase in a liability for income taxes payable or a reduction of an income tax refund receivable
2. A reduction in a deferred tax asset or an increase in a deferred tax liability
3. Both items 1 and 2

.54 An enterprise that presents a classified statement of financial position should classify a liability for unrecognized tax benefits as current to the extent that the enterprise anticipates making a payment within one year or the operating cycle, if longer. An income tax liability should not be classified as a deferred tax liability unless it results from a taxable temporary difference (that is, a difference between the tax basis of an asset or a liability as calculated using this interpretation and its reported amount in the statement of financial position). This interpretation does not change the classification requirements for deferred taxes.

.55 Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in FASB Statement No. 109 is not an appropriate substitute for the derecognition of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on the sufficiency of future taxable income is unchanged by this interpretation. This interpretation is effective for fiscal years beginning after December 15, 2006.

FIN 48 and Independence

.56 In some instances, making such determinations under FIN 48 can involve relatively complex judgments, and practitioners have asked whether they may assist clients in applying FIN 48 without impairing their independence. At its July 19–20, 2007 meeting, the Professional Ethics Executive Committee (PEEC) considered this question and concluded that a member may assist an attest client in applying FIN 48 provided that the member is satisfied that the client understands the reasons why a specific tax position does or does not meet the more-likely-than-not threshold and the basis for the determination of the amount of related unrecognized tax benefits. In making this determination, the PEEC referred to its longstanding position in AICPA Interpretation 101-3, *Performance of Nonattest Services*, General Requirement No. 2, that the requirement that the client's "designated individual" possess suitable skill, knowledge, or experience to oversee the services does not mean that the individual must possess the technical expertise that the member possesses or the ability to perform or reperform the services.

.57 The PEEC believes that in most cases a member should be able to advise the client about whether a tax position meets the more-likely-than-not threshold and the likelihood that portions of the related tax benefit will not be realized, and adequately inform them of the factors upon which the member's advice was based and thereby enable the client to make an informed judgment on the results of the member's services and take responsibility for the work. In those instances, the PEEC believes that assisting the client in applying FIN 48 would not impair the member's independence. The staff of the AICPA Professional Ethics Division has issued nonauthoritative guidance on this matter by adding Question and Answer No. 23 to the Questions and Answers that appear on the division's Web site at www.aicpa.org/download/ethics/nonattest_q_a.pdf.

On the Horizon

.58 Accountants should keep abreast of accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to your clients or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.59 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and compilation and review projects exist in addition to those discussed here. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing +Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
AICPA Accounting and Review Services Committee (ARSC)	www.aicpa.org/members/div/auditstd/index.htm
Financial Accounting Standards Board (FASB)	www.fasb.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

SSARS Pipeline

.60 The ARSC is currently working on the following potential new projects.

ARSC Clarity Project

.61 The first step in the ARSC's clarity project is the issuance of the proposed SSARS, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services*, as discussed in paragraphs .18–.21 of this alert. The provisions of this proposed statement will apply to existing SSARSs. Over the course of the next few years, the ARSC will examine the existing SSARSs and consider whether any additional revisions to the SSARSs are appropriate.

.62 In addition, the specific terms used to define professional requirements in the SSARSs are not intended to apply to interpretive publications since interpretive publications are not accounting and review standards. It is the ARSC's intention to make conforming changes to the interpretive publications over the next several years to remove any language that would imply a professional requirement when none exists.

Recodification

.63 The ARSC is considering a reorganization of the codification of SSARSs. The resulting codification would be organized as follows:

- SSARS hierarchy
- Guidance with respect to compilations of financial statements
- Guidance with respect to reviews of financial statements
- Guidance with respect to compilations of specified elements, accounts, or items of a financial statement
- Guidance with respect to compilations of pro forma financial information

.64 The ARSC tentatively plans to expose a proposed SSARS during late 2008 or early 2009.

International Standards

.65 The ARSC is committed to harmonizing the SSARSs, where deemed appropriate, with the International Standards for Review Engagements (ISRE). During 2008, the ARSC will consider the guidance in the ISRE and whether revisions to the SSARSs are necessary. It is the belief of the ARSC that such harmonization will assist practitioners, especially those practitioners that are engaged to review the financial statements prepared in conformity with International Accounting Standards (IAS).

OCBOA Accounting Guidance

.66 Over the past few years, many practitioners have noted that it would be beneficial to have nonauthoritative accounting guidance as it relates to OCBOA. The ARSC will lead a cross-functional task force that will develop an OCBOA practice aid that will provide guidance to preparers. A practice aid is expected to be drafted in 2008.

Accounting Pipeline

.67 Presented below are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year alert have not been finalized as of the date of this writing, and thus are included again.

Business Combinations

.68 Phase one of the business combination project resulted in the issuance of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*. In those statements, the FASB eliminated the use of the pooling of interests method of accounting for business combinations and addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. The objective of phase two of this project is to standardize business combination accounting through the convergence of the FASB and International Accounting Standards Board (IASB) accounting standards and by reconsidering the existing guidance for the purchase method of accounting for business combinations. Among the main proposals are:

- All acquisitions of businesses are to be measured at the fair value of the business acquired.
- Substantially all the assets acquired and liabilities assumed of the acquired business are to be recognized and measured at their fair values at the acquisition date.
- Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.69 In June 2005, the FASB and IASB issued a number of exposure drafts, for which comment periods ended in October 2005. Redeliberations began in January 2006 and were completed in June 2007. The FASB and IASB expect to issue final statements during the fourth quarter of 2007. Four standards are expected to be issued:

- Proposed FASB Statement No. 141(R) and International Financial Reporting Standard (IFRS) No. 3(R), *Business Combinations*
- Proposed FASB Statement No. 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*
- Proposed IAS Statement No. 27(R)

.70 Readers should remain alert to the final issuances and visit the FASB Web site for further information.

Fair Value

.71 During phase one of the FASB's fair value option project, the FASB issued FASB Statement No. 159, which was previously discussed. In phase two of the project, the FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase two are expected to begin in the third quarter of 2007. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.72 In December 2006, the FASB issued an exposure draft titled, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure ended in March 2007, and the FASB has begun redeliberations to consider significant issues raised by respondents. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133 including how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entity's financial position, results of operations, and cash flows. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.73 The FASB is working on a project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, to address issues related to the permitted activities of a qualifying special-purpose entity (QSPE), isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, the FASB issued exposure draft, *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During 2007, the FASB expects to address issues related to the permitted activities of a QSPE and then issue another exposure draft during the fourth quarter of 2007 containing potential amendments to FASB Statement No. 140. See the FASB Web site for complete information.

FASB Codification and Retrieval Project

.74 The goal of this FASB project is to create a single, authoritative codification of U.S. GAAP. The codification will integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, EITF, and the SEC). The codification will have a three layered structure: topic, subtopic, and section. The FASB has structured the topics into three primary areas: overall presentation, transactional (or financial statement account), and industry. The overall presentation area addresses presentation of financial information but does not address items such as recognition, measurement, or derecognition. The transactional or financial statement account area addresses accounting recognition, measurement, or derecognition. The industry area includes guidance unique to the industry. A codification draft is expected in 2007 and will have an extended verification period to ensure that it accurately reflects U.S. GAAP. Once the FASB addresses respondent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards. Readers can track progress of the Codification and Retrieval Project on the FASB Web site at www.fasb.org/project/codification&retrieval_project.shtml.

GAAP Hierarchy

.75 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69 (AICPA, *Professional Standards*, vol. 1, AU section 411). However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the accountant, which is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.76 ***Proposed FASB EITF Issues.*** Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.77 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

Publications

.78 The following publications deliver valuable guidance and practical assistance as tools to be used on your engagements (product numbers appear in parentheses):

- *Compilation and Review Engagements—Essential Questions and Answers* (product no. 006622kk)
- *Review Engagements: New and Expanded Guidance on Analytical Procedures and Inquiries* (product no. 006618kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)
- *Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services—SSARS No. 15* (product no. 060653kk)
- *Compilation and Review Engagement Essentials* (product no. 733677)

AICPA reSOURCE: Accounting and Auditing Literature

.79 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, TPAs, 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.

Continuing Professional Education

.80 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs performing compilation and review engagements. Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.81 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 for nonmembers) for a new subscription and $119 ($369 for nonmembers) for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to those performing compilation and review engagements include the following:

- *Accounting Services and Compilation Engagements: Documentation*
- *Compilation Engagements: Types and Scope*
- *Other Comprehensive Bases of Accounting (OCBOA): An Introduction*
- *Drafting Audit, Review, and Compilation Reports*
- *2007 Annual Update—A&A: Compilation and Review Update*
- *Compilation and Review Engagements: Quality Control*
- *Comp & Review Engagements: Environmental, Accounting, and Reporting Issues*
- *Comp & Review Engagements: New Standards and Performance Issues*
- *Compilation and Review: Documentation*
- *Review Engagement Reports*

.82 To register or learn more, visit www.cpa2biz.com.

Webcasts

.83 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high-quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.84 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

Member Service Center

.85 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.86 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. You can reach the Technical Hotline at (888) 777-7077.

Ethics Hotline

.87 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.

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.88 This *Compilation and Review Alert* replaces *Compilation and Review Alert—2006/07*.

.89 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 them with us. Any other comments that you have about this Alert would also be appreciated. You may e-mail these comments to killuzzi@aicpa.org or write to:

Kristy L. Illuzzi, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

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Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, Practice Bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+ Resources/Accounting+and+ Auditing/Accounting+ Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+ Resources/Accounting+and+ Auditing/Audit+and+Attest+ Standards/Accounting+and+ Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+ Resources/Accounting+and+ Auditing/Audit+and+Attest+ Standards/Professional+ Issues +Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org

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AAM Section 8030

Health Care Industry Developments—2007/08

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
HEALTH CARE INDUSTRY DEVELOPMENTS—2007/08

This Audit Risk Alert is intended to provide auditors of financial statements of health care organizations with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

Zachary T. Donahue, CPA
Senior Technical Manager
Accounting and Auditing Publications

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your health care industry audits. This alert can also be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory 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 financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The health care industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic, and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the entity's financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, GDP increased at an annual rate of 2.9 percent in 2006, consistent with the pace of growth experienced in 2005 when GDP increased by 3.1 percent. During the first quarter of 2007, GDP increased by an annual rate of only 0.6 percent. However, according to second quarter preliminary estimates, GDP increased at an annual rate of 4.0 percent.

.11 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, with an annual average rate of 4.6 percent representing approximately 7 million people. The 2006 rates represent the lowest annual rate and total number of jobless since 2000, according to the U.S. Department of Labor Bureau of Labor Statistics. During the first half of 2007, the unemployment rate averaged 4.5 percent. This data further demonstrates the economic growth the U.S. has experienced since the beginning of 2006.

.12 After a period of rising rates during the first half of 2006, the Federal Reserve kept its target for the federal funds rate at 5.25 percent during its last 10 meetings (June 2006–August 2007). At that time, the Federal Reserve indicated future federal fund rate adjustments would likely depend upon the outlook for economic growth and inflation. Since its August 2007 meeting, and in response to shaky financial market conditions, the Federal Reserve announced that it would provide reserves as necessary through the open market to facilitate the orderly functioning of financial markets by promoting trading in the federal funds market at rates close to the 5.25 percent target rate. The Federal Reserve then announced on August 17, 2007 that financial market conditions had deteriorated, and tighter credit conditions and increased uncertainty has the potential to restrain economic growth. The Federal Open Market Committee (FOMC) is closely monitoring the situation and is prepared to act as necessary to mitigate adverse effects on the economy arising from the disruptions in financial markets. Shortly after this August 17th release, the Federal Reserve approved actions to decrease the discount rate at the Federal Reserve Banks of Boston, Philadelphia, Cleveland, Richmond, Atlanta, Chicago, Minneapolis, Kansas City, Dallas, and St. Louis from 6.25 percent to 5.75 percent. This narrows the spread between the primary credit rate and the target federal funds rate to 50 basis points. Auditors should remain alert to developments in the financial markets and how it may affect your audit engagements.

Industry Trends and Conditions

Centers for Medicare and Medicaid Services

.13 On August 1, 2007, the Centers for Medicare and Medicaid Services (CMS) issued a final rule that takes significant steps to improve the accuracy of Medicare's payment under the acute care hospital inpatient prospective payment system (IPPS), while providing additional incentives for hospitals to engage in quality improvement efforts. The IPPS payment reforms would restructure the inpatient diagnosis-related groups (DRGs) to account more fully for the severity of each patient's condition. In addition, the rule includes important provisions to ensure that Medicare no longer pays for the additional costs of certain preventable conditions (including certain infections) acquired in the hospital. Auditors should be aware of the impact this change will have on health care organizations. Visit the CMS Web site at www.cms.hhs.gov/AcuteInpatientPPS/IPPS/list.asp for further information.

Sarbanes-Oxley Act and Not-for-Profit Health Care Organizations

.14 Since the issuance of the Sarbanes-Oxley Act, several states' legislators, regulators, and other elected or appointed officials have sought to duplicate or extend its provisions to nonpublic companies and their auditors on the state level. The AICPA formed a Special Committee on State Regulation to assist with responses to state issues resulting from the Sarbanes-Oxley Act.

.15 To obtain an overview of accounting reform state legislative activity, go to the AICPA Web site at www.aicpa.org/statelegis/index.asp. If you are an issuer subject to the provisions of Sarbanes-Oxley, you can get information about some of the recent Securities and Exchange Commission (SEC) activities to implement Sarbanes-Oxley in the *SEC and PCAOB Alert—2007/08* (product no. 022497kk).

.16 The Public Company Accounting Oversight Board (PCAOB) issued Auditing Standard No. 5, effective July 2007. See "Recent Auditing and Attestation Pronouncements and Related Guidance" below for further discussion.

Health Care Technological Developments

.17 New technologies are continually being developed that may have a significant affect on future financial results of health care organizations. Your health care industry clients may be expanding their investment in technology in ways that may have received less attention. For example, your clients may want to achieve greater staff efficiency and productivity, improve patient care quality and safety, increase compliance with regulatory requirements, update facility and equipment modernization, and update information processing and sharing. Increasingly, individuals seek health information online before consulting with medical professionals. Additionally, researchers are working on new technologies that could lead to the development of devices allowing individuals to take certain measurements (blood pressure, temperature, heart rate) at home and then transmit that information electronically to their medical professional, which could reduce the number of necessary trips to their medical professional's office. Increasing use of technology by health care organizations includes electronic medical records, bar coding medical supplies, computerized physician ordering systems and bedside laboratory testing. The U.S. Department of Health and Human Services (HHS) continues to announce efforts to promote the use of information technology (IT) in health care, including initiatives to promote creation of electronic health records (EHR) for Americans. The American Health Information Community recently recommended that EHR adoption be its top priority and made plans to standardize secure and widely available solutions for accessing current and historical laboratory results and interpretations in the near future.

.18 As you plan your audits, consider in particular the effects of IT on internal control and your ability to sufficiently assess the associated risks of material misstatement. Auditors should consider the guidance in AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1) regarding the effect of IT on internal control.

.19 Auditors may find their health care organization clients are using off-balance-sheet financing arrangements, such as operating leases, to finance IT equipment acquisitions. Auditors should determine that the accounting guidance in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (FASB Statement) No. 13, *Accounting for Leases*, as amended and interpreted for classification of leases as operating leases, capital leases, or sale-type leases, is being followed. FASB Statement No. 13, paragraph 1, states that a lease is an agreement conveying the right to use property, plant, and equipment (land or other depreciable assets), usually for a stated period of time. Emerging Issues Task Force (EITF) Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease," provides guidance on how to determine whether an arrangement contains a lease that is within the scope of FASB Statement No. 13. Governmental health care entities should also consider the guidance in Governmental Accounting Standards Board (GASB) Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*.

.20 A number of SEC registrants recently restated their financial statements relating to lease accounting. Specifically, restatements occurred related to the amortization of leasehold improvements; recognition of rent when lease terms of an operating lease contain what is referred to as rent holidays; and incentives related to leasehold improvements. The Chief Accountant of the SEC issued a letter in February 2005 to the AICPA's Chairman of the Center for Public Company Audit Firms. The letter clarified the SEC staff's interpretation of certain accounting issues and their application under generally accepted accounting principles (GAAP) relating to operating leases. The letter focused on specific concerns regarding the appropriate accounting for operating leases; restatements resulting from the correction of errors that deviate from the lease accounting standards; and clear and concise disclosures of both operating and capital leases. Non-SEC registrants should also ensure compliance with the lease accounting standards and related interpretations set forth by the FASB and make any necessary restatements or corrections.

.21 Auditors of nongovernmental entities should consider the guidance in Statement of Position (SOP) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, (AICPA, *Technical Practice Aids*, ACC sec. 10,720), on accounting for the costs of computer software developed or obtained for internal use and for determining whether the costs of computer software developed for internal use are capitalizable.

Complex Financing Structures, Investments, and Access to Capital

.22 Some health care organizations are dependent on external sources of funds to satisfy their capital needs. Many health care organizations finance acquisitions, additions, and renovations with long-term debt. Health care organizations may have more complex structures that use swaps or other derivative instruments to meet their financing objectives, such as changing their liabilities from fixed-rate borrowings to variable rate borrowings, or vice versa. Auditors should determine that the method specified by generally accepted accounting principles (GAAP) to determine the value of derivatives is being followed. When auditing derivatives, auditors should follow the guidance in AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1). In addition, auditors should follow the guidance in the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

.23 Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," (AICPA, *Professional Standards*, vol. 1, AU sec. 9332.01–.04) which interprets AU section 332, provides guidance regarding the adequacy of audit evidence with respect to the existence and valuation assertions in confirmations received from third parties, where a readily determinable fair value does not exist, and the auditor determines auditing procedures should include verifying the existence and testing the measurement of the investments. For example, an entity may have an investment in a hedge fund that is reported at fair value for which a readily determinable fair value does not exist. Further, the hedge fund may own interests in investments in limited partnership interests or other private equity securities for which a readily determinable fair value does not exist. As part of the auditor's procedures in accordance with AU section 332, an auditor typically would satisfy the existence assertion through confirmation with the hedge fund, examination of legal documents, or other means. In confirming existence, the auditor may request the hedge fund to indicate or confirm the fair value of the entity's investment in the hedge fund, including the fair value of investments held by the hedge fund. In some circumstances, the hedge fund will not provide detailed information about the basis and method for measuring the entity's investment in the hedge fund, nor will they provide information about specific investments held by the hedge fund. This interpretation illustrates examples of information auditors may receive in a third-party confirmation (in the aggregate or on a security-by-security basis) and provides interpretative guidance for auditors about the adequacy of audit evidence provided in those examples.

.24 A number of health care organizations are entering into build-to-suit transactions. Auditors should consider the guidance in EITF Issue No. 97-10, "The Effect of Lessee Involvement in Asset Construction." EITF Issue No. 97-10 is not limited to build-to-suit real estate projects; it applies to all asset construction projects with lessee involvement.

.25 As discussed in EITF Issue No. 97-10, if the health care organization is a lessee and has substantially all of the construction period risks, then the lessee is considered the owner of the asset during the construction period. The transaction is effectively a sale and leaseback of assets and is within the scope of FASB Statement No. 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of Lease Term, and Initial Direct Costs of Direct Financing Leases*. Evaluation of whether the lessee has substantially all of the construction period risks is based on a test similar to the 90 percent recovery-of-investment test described in FASB Statement No. 13 as well as six special provisions contained in EITF Issue No. 97-10.

Changes to Risk Profiles in Provider Contracts

.26 The negotiated contracts between health care systems and managed care companies can be complex and could be changing the historical risk profiles in those contracts. Auditors should consider the effect of any changes, whether to full risk, away from full risk, or new payment methodologies on fee-for-service on the financial statements when auditing their health care industry clients. Auditors should also consider the need to perform additional auditing procedures, including a careful review of the contract terms. These contracts can increase the difficulty in properly estimating and accounting for revenue under these arrangements.

Costs of Providing Health Care Services

.27 Governments and private employer providers of health care insurance continue to focus on the costs of health care. A number of employers announced reductions or eliminations of health care coverage to employees or retirees. There are government- and private-sector initiatives to promote consumer-directed health care and to expand use of health savings accounts. These changes can lead to increased costs to collect and higher bad debts.

Uninsured Patients

.28 Uninsured patient charges, billings, and collections have been in the spotlight in recent years. Your health care organization clients may be continuing to evaluate their policies and procedures for providing patient care for the uninsured. Auditors should be aware of the impact of changes to these policies and procedures and how this may affect the assessment of risks of material misstatements.

Legislative and Regulatory Developments

.29 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. The brief summaries provided in this section of the alert are for informational purposes only. Please refer to the full text of the regulations and other documents that are discussed.

SEC

Executive Compensation and Related Person Disclosure

.30 In November 2006, the SEC adopted amendments to the disclosure requirements for executive and director compensation, related person transactions, director independence and other corporate governance matters, and security ownership of officers and directors. These amendments apply to disclosure in proxy and information statements, periodic reports, current reports, and other filings under the Securities Exchange Act of 1934 and to registration statements under the Exchange Act and the Securities Act of 1933. These amendments are intended to make proxy and information statements, reports, and registration statements easier to understand. Furthermore, they are designed to provide investors with a clearer and more complete picture of the compensation earned by a company's principal executive officer, financial officer, highest paid executive officers, and members of its board of directors.

.31 Companies must comply with these disclosure requirements in Form 8-K for triggering events that occur on or after November 7, 2006, and in Forms 10-K and 10-KSB for fiscal years ending on or after December 15, 2006. Other provisions apply and may be found on the SEC's Web site at www.sec.gov/rules/final/2006/33-8732a.pdf.

.32 In December 2006, the SEC adopted amendments to the disclosure requirements for executive and director compensation. The amendments to Item 402 of Regulations S-K and S-B revise Summary Compensation Table and Director Compensation Table disclosure with respect to stock awards and option awards to provide disclosure of the compensation cost of awards over the requisite service period, as described in FASB FAS No. 123 (revised 2004) *Share-Based Payment* (FAS 123R). Additional information may be found on the SEC's Web site at www.sec.gov/rules/final/2006/33-8765.pdf.

Continuing Disclosure Filings Under SEC Rule 15c2-12—DisclosureUSA

.33 Because of the SEC rule 15c2-12 (17 CFR 240.15c2-12), issuers and other obligated persons of most municipal securities offerings over set dollar amounts make *continuing disclosures* of annual financial information and disclosures of certain, specific *material events*. In the past, issuers and other obligated persons usually have submitted documents with those disclosures in hardcopy format directly to each of the nationally recognized municipal securities information repositories (NRMSIRs) and applicable state information depositories (SIDs).

.34 In 2004, DisclosureUSA.org began operating as an Internet-based "electronic post office" for those filings. Instead of mailing numerous hard copies to NRMSIRs and SIDs, issuers and other obligated persons and their dissemination agents may instead submit documents in any computer file format to DisclosureUSA.org at no charge. Those who currently do not wish to file electronic documents may instead file paper documents for a small fee. DisclosureUSA.org will send the filings to each NRMSIR and applicable SID. The SEC staff issued an Interpretative Letter authorizing the use of DisclosureUSA.org to meet the continuing disclosure requirements and encourages that use. The SEC is expected to consider mandating the use of DisclosureUSA for all rule 15c2-12 filings. In September 2005, DisclosureUSA announced that 2,150 users had registered at the central post office Web site in the first 12 months the site was live. During that time period, they received filings from every U.S. state, Washington D.C., Puerto Rico, and the U.S. Virgin Islands.

.35 Instructions for making electronic and paper filings are at www.DisclosureUSA.org. The SEC staff Interpretative Letter is available on the SEC Web site at www.sec.gov/info/municipal/texasmac090704.pdf. The SEC Office of Municipal Securities release, "Tips for Making Continuing Disclosure Filings" is available on the SEC Web site at www.sec.gov/info/municipal/discfiletips.htm.

.36 Auditors may want to consider advising their clients who are issuers and conduit borrowers to consider the use of DisclosureUSA.org for their SEC Rule 15c2-12 filings. Although DisclosureUSA allows the submission of electronic documents in any computer file format, the NRMSIRs and SIDs convert the files to an Adobe Acrobat Portable Document Format (PDF) before releasing them to requesting parties. Auditors may want to consider recommending to auditees that they submit their filings to DisclosureUSA in a PDF file to reduce the possibility of subsequent data corruption. The PDF also facilitates the security of financial statements and other information that many entities post on their Internet sites.

Office of Inspector General

Medicare and State Health Care Programs: Fraud and Abuse

.37 In August 2006, the Office of Inspector General (OIG) issued the final rule, "Medicare and State Health Care Programs: Fraud and Abuse; Safe Harbors for Certain Electronic Prescribing and Electronic Health Records Arrangements Under the Anti-Kickback Statute." As required by the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MMA), this final rule establishes a new safe harbor under the federal antikickback statute for certain arrangements involving the provision of electronic prescribing technology. Specifically, the safe harbor would protect certain arrangements involving hospitals, group practices, and prescription drug plan sponsors and Medicare Advantage (MA) organizations that provide to specified recipients certain nonmonetary remuneration in the form of hardware, software, or IT and necessary training services used solely to receive and transmit electronic prescription information. This regulation became effective October 10, 2006.

Publications: Work Plan and Semiannual Report

.38 The OIG of HHS investigates and monitors the Medicare and Medicaid programs. On the HHS OIG Web site at www.oig.hhs.gov, you can access two publications that can be helpful in obtaining information about current projects and investigative activities of the OIG: the OIG Work Plan Fiscal Year 2007 (Work Plan) and the OIG October 1, 2006 to March 31, 2007 Semiannual Report.

.39 The work plan includes a section with ongoing and proposed OIG projects planned for CMS. The projects planned for CMS are presented by categories that include hospitals (Medicare and Medicaid); home health (Medicare); nursing homes (Medicare); managed care (Medicare); physicians and other health professionals (Medicare); Medicaid administration, including upper payment limit programs; and other services (Medicare and Medicaid).

.40 For a summary of the activities of the OIG for the six-month period ended March 31, 2007, including notable criminal enforcement actions, civil settlements, and administrative sanctions, see the OIG Semiannual Report.

Centers for Medicare and Medicaid Services

Services Provided to Undocumented Aliens

.41 Section 1011 of the MMA, Federal Reimbursement of Emergency Health Services Furnished to Undocumented Aliens, provides $250 million per year for fiscal years 2005–2008 for payments to eligible providers for emergency health services provided to undocumented aliens and other specified aliens. Two-thirds of the funds will be divided among all 50 states and the District of Columbia based on their relative percentages of undocumented aliens. One-third will be divided among the six states with the largest number of undocumented alien apprehensions.

.42 From the respective state allotments, payments will be made directly to hospitals, certain physicians, and ambulance providers for some or all of the costs of providing emergency health care required under Section 1867 and related hospital inpatient, outpatient, and ambulance services to eligible individuals. Eligible providers may include an Indian Health Service facility, whether operated by the Indian Health Service or by an Indian tribe or tribal organization. A Medicare critical access hospital is also a hospital under the statutory definition. Payments under Section 1011 may only be made to the extent that care was not otherwise reimbursed (through insurance or otherwise) for such services during that fiscal year.

.43 Payments may be made for services furnished to certain individuals described in the statute as (1) undocumented aliens, (2) aliens who have been paroled into the United States at a U.S. port of entry for the purpose of receiving eligible services, and (3) Mexican citizens permitted to enter the United States for not more than 72 hours under the authority of a biometric, machine-readable, border-crossing identification card (also referred to as a *laser visa*) issued in accordance with the requirements of regulations prescribed under a specific section of the Immigration and Nationality Act.

U.S. Department of Health and Human Services

Value-Driven Health Care

.44 HHS has focused a spotlight on health care transparency. They feel consumers deserve to know the quality and cost of their health care, and they feel health care transparency provides consumers with the necessary information, and the incentive, to choose health care providers based on value.

.45 According to the HHS Web site, www.hhs.gov/valuedriven, health care transparency is built on four interconnected cornerstones.

1. **Connect the systems:** Every medical provider has some system for health records. Increasingly, those systems are electronic. Standards need to be identified so all health information systems can quickly and securely communicate and exchange data.

2. **Measure and publish quality:** Every case and every procedure has an outcome. Some are better than others. To measure quality, we must work with doctors and hospitals to define benchmarks for what constitutes quality care.

3. **Measure and publish price:** Price information is useless unless cost is calculated for identical services. Agreement is needed on what procedures and services are covered in each episode of care.

4. **Create positive incentives:** All parties—providers, patients, insurance plans, and payers—should participate in arrangements that reward both those who offer and those who purchase high quality, competitively priced health care.

.46 HHS published the final rule, *HIPAA Administrative Simplification: Enforcement*, in the February 16, 2006 *Federal Register* to impose civil monetary penalties on entities that violate the rules adopted by HHS to implement HIPAA Administrative Simplification provisions. The final rule provides that in the context of the HIPAA rules, a covered entity generally could be held liable for a civil monetary penalty based on the actions of any agent acting within the scope of the agency. A business associate will often be an agent of a covered entity. A covered entity that complies with the HIPAA rules governing business associates will not be held liable for a business associate's actions that violate the rules. If the covered entity does not enter into the requisite arrangements or contracts or does not take reasonable steps to cure a breach or end a violation by the business associate, it could be held liable for the actions of the business associate.

IRS

Community Benefit Survey

.47 In May 2006, the IRS sent a questionnaire to approximately 500 tax-exempt hospitals inquiring how they provide and report benefits to the community. Providing community benefit is required for hospitals seeking and retaining tax-exempt status under section 501(c)(3) of the Internal Revenue Code. In July 2007, the IRS released an interim report summarizing the responses to the questionnaire. According to the report, nearly all hospitals reported that they provided various types of community benefit. Although 97 percent of the responding hospitals said they have a written uncompensated care policy, there was no clear definition of what constitutes "uncompensated care." This lack of uniformity in definitions and reporting called for a separate schedule for hospitals on Form 990. As a result, the IRS recently released a discussion draft of that form to include a new Schedule H, where hospitals will report how they provide community benefit. The executive summary of the report is located at www.irs.gov/charities/charitable/article/0,,id=172267,00.html.

Redesigned Form 990 for Tax-Exempt Organizations

.48 In June 2007, the IRS released its draft Form 990. The discussion draft constitutes a significant redesign of the Form, which has not been overhauled since 1979. The IRS anticipates using the redesigned form for the 2008 tax year (returns filed in 2009). The proposed redesign does not affect the other forms in the IRS Form 990 series. The redesigned form is based on enhancing transparency, promoting tax compliance, and minimizing the burden on the filing organization. Additional information is located at www.irs.gov/charities/article/0,,id=171216,00.html.

Accounting Issues and Developments

FASB Interpretation No. 48

.49 FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes,* clarifies and expands the accounting and financial reporting for uncertainties related to income taxes. This FASB interpretation is applicable to all business enterprises whether they are taxable businesses or tax-exempt organizations. Tax positions taken by any organization that may represent potential future obligations to a taxing authority (IRS or state revenue department) may have to be recorded under this interpretation. For not-for-profit organizations, examples of tax positions that are subject to FASB Interpretation No. 48 include (1) a decision not to file a Form 990-T or state income tax return; (2) a decision not to characterize an activity as an unrelated business; (3) using an allocation method for expenses between related and unrelated activities; and (4) classifying an entity or a transaction as tax exempt. FASB Interpretation No. 48 also applies to tax-exempt organizations with net operating loss or a net operating loss carryover for unrelated business income tax purposes and tax positions taken in allocating expenses through joint venture and other business relationships with taxable entities.

FASB Staff Position (FSP) 126-1

.50 In October 2006, the FASB issued FASB Staff Position (FSP) FAS 126-1, *Applicability of Certain Disclosures and Interim Reporting Requirements of Obligors for Conduit Debt Securities*. This FSP clarifies the definition of a public entity in certain accounting standards to include entities that are conduit bond obligors for conduit debt securities that are traded in a public market. Most not-for-profit health care organizations that issue tax-exempt debt through governmental authorities fall under this definition of public entity. The FSP, effective for fiscal periods beginning after December 15, 2006, details the accounting standards impacted by the new definition.

.51 One significant impact of this FSP is its amendment of Accounting Principles Board (APB) Opinion No. 28, *Interim Financial Reporting*, requiring that not-for-profit health care organizations that issue quarterly financial information and are within the scope of the FSP to follow the reporting requirements of APB Opinion No. 28. In general, APB Opinion No. 28 requires that the operating results for each interim period be based on the accounting principles and practices used by an organization in preparing its latest annual financial statements unless a change in an accounting practice or policy has been adopted in the current year.

Accounting for Advanced Refunding of Debt

.52 Many health care organizations extinguish debt through a process often referred to as an advanced refunding. FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provides guidance on the accounting for advanced refunding of debt, both for the debt to be treated as extinguished and also for the transfer of the U.S. government securities to the refunding escrow to accomplish the advanced refunding. Application of the statement's provisions generally requires health care organizations to obtain a legal opinion confirming the legal isolation of the transferred assets and the release of the health care organization as the primary obligor of the debt. The legal isolation criteria and the release from being the primary obligor must both be satisfied before an entity can derecognize the transferred assets and the extinguished debt.

Managed Investment Portfolios

.53 Health care organizations often outsource the management of their investment portfolios to third party investment managers. In some cases, the health care organization places restrictions on the trading activities of the third party investment manager such that management maintains control over investment decisions (for example, determining when to buy or sell specific securities). In other cases, there are no such restrictions placed on the third party investment manager. In situations where restrictions have not been imposed, management of the health care organization typically may not assert that they have the intent and ability to hold any impaired investments (that is, fair value is less than cost) until recovery. Without the intent and ability to hold an impaired security until anticipated recovery, the health care organization would be precluded from considering the severity and duration of the impairment in making the determination as to whether the impairment is "other-than-temporary." Accordingly, for not-for-profit health care organizations that classify their externally managed investment portfolio as "other-than-trading," any impairment would be considered other-than-temporary. Other-than-temporary impairment losses are included within the performance indicator, and a new cost basis for the related securities is established.

.54 Not-for-profit health care organizations that outsource the investment management function and classify their investment portfolios as other-than-trading should review the investment management agreements and determine the appropriate accounting treatment for any impaired securities. Many health care organizations are considering designating their investment portfolio as "trading." For trading securities, unrealized gains and losses on investments are included in the performance indicator, making it unnecessary to consider whether any impairments are other-than-temporary.

Other-Than-Temporary Impairment

.55 In February 2007, the SEC clarified existing guidance on asset impairment contained within SEC Staff Accounting Bulletin (SAB) No. 59, *Other-Than-Temporary Impairment of Certain Investments in Debt and Equity Securities*. Although SAB No. 59 contains several factors which must be considered in any determination of an other-than-temporary impairment, one key factor centers on an entity's intent and ability to hold an investment whose fair value is below cost ("impaired securities") for a sufficient period of time to allow for a potential recovery in that investment's fair value. Prior to the SEC's recent clarification of the SAB, the question was whether or not an entity could truly assert both a positive intent and ability to retain impaired securities until those securities' fair value recovers for investments managed by outside portfolio managers, where manager restrictions on selling impaired securities did not exist. Through its SAB No. 59 clarification, the SEC has made it clear that for any investment managed by an external portfolio manager, where restrictions are not placed on that manager with regard to selling impaired securities, an entity can no longer assert that it has both the positive intent and ability to hold impaired securities through potential recovery. This clarification has a potentially significant impact on any entity's classification and accounting for investments, as certain investments that may have historically been classified as other-than-trading may be more appropriately classified as trading.

.56 From an accounting perspective, FASB Statement No. 124, *Accounting for Certain Investments in Debt and Equity Securities by Not-for-Profit Organizations* and Chapter 4, "Investments," of AICPA Audit and Accounting Guide *Health Care Organizations*, prescribe the proper accounting for investments held by not-for-profit entities based on their classification. (Furthermore, FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, provides relevant guidance for the cash flows statement impact of accounting for investments.) Specifically, for investments classified as "trading," both unrealized investment gains and losses must be recognized as a component of net income. For investments classified as other-than-trading, unrealized investment gains and losses must be recognized as a component of unrestricted changes in net assets (or restricted changes in net assets for donor restricted funds which may be held in foundations, with the exception of other-than-temporary unrealized losses, which are recognized immediately as a component of the performance indicator (excess of revenues over expenses).

Quantifying Misstatements

.57 On September 13, 2006, the SEC released SAB No. 108, Topic 1N, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. Although the guidance is directed at registrants, it is also important for auditors of registrants as they consider and quantify the effects of misstatements in financial statements. The issuance provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement.

.58 Two methods have commonly been used to quantify such errors. Under one method, the rollover approach, the error is quantified as the amount by which the current year income statement is misstated. The other common method, the iron curtain approach, quantifies the error as the cumulative amount by which the current year balance sheet is misstated. Exclusive reliance on an income statement approach can result in a registrant accumulating errors on the balance sheet that may not have been material to any individual income statement, but that nonetheless may misstate one or more balance sheet accounts. Similarly, exclusive reliance on a balance sheet approach can result in a registrant disregarding the effects of errors in the current year income statement that result from the correction of an error existing in previously issued financial statements.

.59 The SEC staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The SEC staff believes that this can be accomplished by quantifying errors under both a balance sheet and an income statement approach and by evaluating errors measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a material misstatement after considering all relevant quantitative and qualitative factors.

.60 If, in correcting an error in the current year, an error is material to the current year's income statement, the prior year financial statements should be corrected, even though such a revision previously was, and continues to be, immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements. However, registrants electing not to restate prior periods should follow the disclosure requirements specified in SAB No. 108. In general, SAB No. 108 is effective for financial statements for fiscal years ending after November 15, 2006, with earlier application encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006, and filed after the SAB's publication date of September 13, 2006. For additional accounting and transition information, see the issuance at www.sec.gov/interps/account/sab108.pdf.

.61 Since the issuance of SAB No. 108, the FASB has received inquiries about the application of SAB No. 108 to the private sector since they are not bound by SAB No. 108. The inquiries raised concerns that diversity will exist in the private sector relating to the determination of materiality associated with errors caused by the carryover or reversal of prior-year misstatements.

.62 On March 13, 2007, the FASB exposed for comment proposed FASB Staff Position Financial Accounting Standard (FSP FAS) No. 154-a, *Considering the Effects of Prior-Year Misstatements When Quantifying Misstatements in Current-Year Financial Statements*, which proposed guidance on how to evaluate and account for the correction of errors identified from the quantification of misstatements associated with the carryover or reversing effects of prior-year misstatements on current year financial statements. This proposed FSP applied to nongovernmental entities that are not subject to the requirements of SAB No. 108, which includes privately held entities and not-for-profit organizations. In absence of this guidance, private companies would not be permitted to have the same opportunity to clean up their balance sheets for passed prior-year audit adjustments without restating prior years, as allowed for public companies under SAB No. 108. The comment period for this FSP ended on April 30, 2007, and in its August 1, 2007 FASB Board Meeting, the FASB decided not to issue a final FSP and removed the project from its agenda.

Recent Auditing and Attestation Pronouncements and Related Guidance

.63 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal* *of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.64 The Public Company Accounting Oversight Board (PCAOB) establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for periods beginning on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A), to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120) • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	See "AICPA Risk Assessment Standards" in this alert.

(continued)

SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) Issue date: December 2005	SAS No. 103 supersedes SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) and amends AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1). Effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted, this SAS establishes standards and provides guidance to an auditor of a nonissuer on audit documentation.
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective for periods ending on or after December 15, 2006.
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325.01–.04), which interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.

Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330.01–.06), which interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.
AICPA TPA TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This practice alert responds to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.
AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This practice alert provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditor's report.

The Auditor's Communication With Those Charged With Governance

.65 In December 2006, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and is effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to 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. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.66 SAS No. 114 recognizes the importance of effective two-way communication to the audit. It provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires significant matters communicated with those charged with governance to be documented.

Identifying Those Charged With Governance

.67 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those 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.

.68 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.69 Since there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.70 In May 2006, the AICPA ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. The new SAS is applicable

whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. However, with the adoption of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, the PCAOB redefined these terms, which now differ from SAS No. 112.

- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.

- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, as well as indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.

- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management, and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.

- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.

- Contains illustrative written communications to management and those charged with governance.

How Revisions of SAS No. 112 Will Affect Practice

.71 As auditors gain a better understanding of what needs to be communicated to management and those charged with governance, there may be more control deficiencies that are identified as significant deficiencies and material weaknesses, and communicated to management and those charged with governance. Auditors may emphasize and therefore spend more time evaluating identified control deficiencies than in the past.

Discussions With Management and Others

.72 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. Auditors may have to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor who does not provide attest services for the client can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.73 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of material weaknesses. Another reason is that auditors have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in written communication as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.74 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present, because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented, detected, and corrected by the client.

Issues for Audits of Smaller Entities

.75 One issue that may arise in audits of smaller entities is the possibility of increased costs as a result of the auditor's time spent documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.76 Another issue that may cause concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, detecting, or correcting material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, since doing so would impair independence.[1] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.77 The new requirements of SAS No. 112 introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing.

.78 The AICPA has published the AICPA Audit Risk Alert titled *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in implementation of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

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[1] See Ethics Ruling 101-3, "Performance of nonattest services," of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

AICPA Risk Assessment Standards

.79 In March 2006, the AICPA ASB issued eight SASs referred to as the risk assessment standards (SAS Nos. 104–111). Although the SASs include many of the underlying concepts and detailed performance requirements contained in existing standards, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risk of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between the risks, controls, audit procedures, and conclusions. The risk assessment standards are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier applications permitted. The following table lists the eight SASs and their effects on existing standards.

Statement on Auditing Standards	*Effect on Existing Standards*
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")* (AICPA, *Professional Standards*, vol. 1, AU sec. 230)	This statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230A).
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	This statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A).
SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)	This statement supersedes SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326A).
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)	This statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312A).
SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)	This statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 310), and supersedes SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A).
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314)	This statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1, AU sec. 318)	This statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).

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SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)	This statement amends SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350A).

Key Provisions of the Risk Assessment Standards

.80 Whether due to error or fraud, the new risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks to the client's business and the mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations of the Treadway Commission's (COSO) framework, www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs will most likely result in significant changes to firm audit methodologies and the training of personnel. Therefore, it is recommended that auditors allow ample time in advance of the required implementation date. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Companion Audit Guide

.81 In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Audit Documentation Technical Practice Aids

.82 In May 2007, the ASB issued two practice aids related to SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which was issued in December 2005.

.83 Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.84 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" discusses whether the provisions of SAS No. 103 related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Practice Alert No. 07-1, Dating of the Auditor's Report and Related Practical Guidance

.85 A key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.86 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date
- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.87 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf. Readers should also note the PITF is currently working on a practice alert that addresses auditing and other considerations related to electronic information which it plans to issue during the third quarter of 2007.

PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements

.88 In May 2007, the PCAOB adopted Auditing Standard No. 5, which was later approved by the SEC on July 25, 2007. This standard replaces Auditing Standard No. 2. Auditing Standard No. 5 is principles-based and presents a risk-based, top-down approach designed to increase the likelihood that material weaknesses will be found before resulting in a material misstatement of a company's financial statements, while eliminating unnecessary procedures. The standard was also designed to make audits more scalable for smaller or less complex companies. The PCAOB worked closely with the SEC to coordinate Auditing Standard No. 5 with the guidance to public company management that was approved by the SEC in May 2007. Mark Olson, PCAOB Chairman, stated "The new standard is more risk-based and scalable, which will better meet the needs of investors, public companies, and auditors alike."

.89 This new standard is required for all audits of internal control for fiscal years ending on or after November 15, 2007. However, early adoption is permitted and encouraged. For more information, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk).

Recent AICPA Independence and Ethics Pronouncements

.90 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.91 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions (FSPs) (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA Statement of Position (SOP) 07-1 (AICPA, *Technical Practice Aids*, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*
TIS section 6140.20–.22 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss not-for-profit organizations fund-raising expenses.
TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various employee benefit plan topics.
TIS section 6300.25–.35 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various issues related to SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.92 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the health care 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. The AICPA general *Audit Risk Alert—2007/08* and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or go online at www.cpa2biz.com.

Fair Value Measurements

FASB Statement No. 157

.93 In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

.94 Prior to this statement, there were different definitions of fair value and guidance for applying those definitions was dispersed among many accounting pronouncements. Difference in the existing guidance created inconsistencies that added to the complexity in applying generally accepted accounting principles (GAAP). FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. Readers can access the full text of FASB Statement No. 157 on the FASB Web site at www.fasb.org.

FASB Statement No. 159

.95 Subsequent to the issuance of FASB Statement No. 157, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and No. 157.

.96 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157. The choice to adopt early should be made within 120 days of the beginning of the fiscal year of adoption (for calendar year end entities, by April 2007), provided the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year of adoption. The FASB and SEC have expressed concern in the way some early adopters have applied the transition provisions of the standard. The AICPA Center for Audit Quality (CAQ) issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard such as this is applied in a good faith manner consistent with those objectives and principles. Specifically the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

On the Horizon

.97 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to the health care industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

.98 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. 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 in addition to those discussed here. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+ Professional+Conduct/Professional+ Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Overhaul Project—AICPA Audit and Accounting Guide Health Care Organizations

.99 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Health Care Organizations*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1996. During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.

Auditing Pipeline—Nonissuers

ASB Clarity Project

.100 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB approved for exposure a discussion paper titled *Improving the Clarity of ASB Standards*. This discussion paper seeks feedback on proposed changes to the standards, including:

- Establishing objectives for each of the standards, and the auditor's obligations related to the objectives.
- Structural and drafting improvements to make the standards easier to read and understand.
- Inclusion, in the explanatory material of the standards, of special considerations related to audits of public entities and small entities.
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards.

.101 The period to comment ended June 15, 2007. The discussion paper can be accessed at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

Convergence With International Standards

.102 The ASB has created a number of task forces charged with monitoring specific activities of the International Auditing and Assurance Standards Board (IAASB) and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of International Standards on Auditing (ISA). The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.103 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, the ASB previously decided to defer to issuance of a final revised AT section 501 until the PCAOB issued its amendments and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www.aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*

.104 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards titled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the

GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA, *Professional Standards*, vol. 1, AU sec. 411]) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www. fasb.org. The ASB will issue its final SAS coincidentally with the FASB's and PCAOB's issuance of their final standards.

Auditing Pipeline—Issuers

.105 Guidance issued by the PCAOB is included in "Recent Auditing and Attestation Pronouncements and Related Guidance" in this alert. For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), mentioned previously.

Accounting Pipeline

.106 Presented below are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year alert have not been finalized as of the date of this writing, and thus are included again.

Business Combinations

.107 Phase one of the business combination project resulted in the issuance of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*. In those statements, the FASB eliminated the use of the pooling of interests method of accounting for business combinations and addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. The objective of phase two of this project is to standardize business combination accounting through the convergence of the FASB and International Accounting Standards Board (IASB) accounting standards and by reconsidering the existing guidance for the purchase method of accounting for business combinations. Among the main proposals are the following:

- All acquisitions of businesses be measured at the fair value of the business acquired.
- Substantially all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.
- Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.108 In June 2005, the FASB and IASB (the Boards) issued a number of exposure drafts for which comment periods ended in October 2005. Redeliberations began in January 2006 and were completed in June 2007. The Boards expect to issue final statements during the third quarter of 2007. Four standards are expected to be issued:

- Proposed FASB Statement No. 141(R) and International Financial Reporting Standard (IFRS) No. 3(R), *Business Combinations*
- Proposed FASB Statement No. 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*
- Proposed International Accounting Standard (IAS) Statement No. 27(R)

.109 Readers should remain alert to the final issuances and visit the FASB Web site for further information.

Fair Value

.110 During phase one of the FASB's fair value option project, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement*

No. 115, which was previously discussed. In phase two of the project, the FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase two are expected to begin in the third quarter of 2007. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.111 In December 2006, the FASB issued an exposure draft entitled, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure ended in March 2007, and the FASB has begun redeliberations to consider significant issues raised by respondents. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133 including how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entity's financial position, results of operations, and cash flows. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.112 The FASB is working on a project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, to address issues related to the permitted activities of a qualifying special-purpose entity (QSPE), isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, the FASB issued exposure draft, *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During 2007, the FASB expects to address issues related to the permitted activities of a QSPE and then issue another exposure draft during the fourth quarter of 2007 containing potential amendments to FASB Statement No. 140. See the FASB Web site for complete information.

Earnings Per Share

.113 The FASB and IASB have been working together to resolve differences between FASB Statement No. 128, *Earnings per Share*, and IAS Statement No. 33, *Earnings per Share*. This project is part of the larger FASB project, Short-term International Convergence, which has resulted in the issuance of a number of FASB Statements. Currently the Boards are addressing significant differences that remain relating to instruments that can be settled in cash or shares and are classified as a liability on an entity's balance sheet. The Boards are considering modifications to the treasury stock method and several scoping issues in which one of the Boards have issued or may issue more detailed implementation guidance on earnings per share that may create a convergence difference. The Boards are expected to issue an exposure draft for public comment during the third quarter of 2007. This exposure draft will be the third exposure draft the FASB has issued on the earnings per share project. The project and current exposure draft can be reviewed on the FASB Web site.

FASB Codification and Retrieval Project

.114 The goal of this FASB project is to create a single, authoritative codification of U.S. GAAP. The codification will integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, EITF, and the SEC). The codification will have a three layered structure: topic, subtopic, and section. The FASB has structured the topics into three primary areas: overall presentation, transactional (or financial statement account), and industry. The overall presentation area addresses presentation of financial information, but does not address items such as recognition, measurement, or derecognition. The transactional or financial statement account area addresses accounting recognition, measurement, or derecognition. The industry area includes guidance unique to the industry. A codification draft is expected in 2007 and will have an extended verification period to ensure that it accurately reflects U.S. GAAP. Once the FASB addresses respondent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards. Readers can track progress of the codification and retrieval project on the FASB Web site at www.fasb.org/project/codification&retrieval_project.shtml.

GAAP Hierarchy

.115 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, who is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in this alert in "Auditing Pipeline—Nonissuers") to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.116 ***Proposed FASB EITF Issues.*** Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.117 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

.118 The following are various resources that practitioners engaged in the health care industry may find beneficial.

Publications

.119 Practitioners may find the following publications useful with respect to the health care industry.

- Audit and Accounting Guide *Health Care Organizations* (2007) (product no. 012617kk)
- Audit and Accounting Guide *Not-for-Profit Organizations* (2007) (product no. 012647kk)
- Government Auditing Standards *and Circular A-133 Audits* (2007) (product no. 012747kk)
- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2007) (product no. 012517kk)
- Audit Guide *Audit Sampling* (2007) (product no. 012537kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2007) (product no. 012777kk)

- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- Audit Risk Alert *Compilation and Review—2007/08* (product no. 022308kk)
- Audit Risk Alert *Independence and Ethics—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Checklists/Checklist Supplement and Illustrative Financial Statements Health Care Organizations* (product no. 009027kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends and Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.120 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. 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.

Continuing Professional Education

.121 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191 [DVD]). 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.
- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

.122 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.123 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics.

.124 To register or learn more, visit www.cpa2biz.com.

Webcasts

.125 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high-quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts.

Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.126 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.127 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.128 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.129 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. You can reach the Technical Hotline at (888) 777-7077.

Ethics Hotline

.130 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.

Industry Conference

.131 The AICPA sponsors an annual Health Care Conference in the fall. The Health Care Conference is a two-day conference designed to update attendees on recent developments related to the health care industry. The National Health Care Industry Conference is an unparalleled opportunity to gain the information and techniques you need to know to stay on top of trends to benefit your practice and your client offerings. With access to some of the nation's top health care specialists, you'll get up-to-the-minute information on the latest developments in health care issues. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA Governmental Audit Quality Center

.132 The Governmental Audit Quality Center (GAQC) is a firm-based voluntary membership Center designed to help CPAs meet the challenges of performing quality audits in this unique and complex area. The GAQC's primary purpose is to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The GAQC also offers resources to enhance the quality of a firm's governmental audits.

.133 The mission of the Governmental Audit Quality Center is to:

- Raise awareness about the importance of governmental audits.
- Serve as a comprehensive resource provider on governmental audits for member firms.
- Create a community of firms that demonstrates a commitment to governmental audit quality.
- Provide Center members with an online forum tool for sharing best practices as well as discussions on audit, accounting, and regulatory issues.
- List member firms to enable purchasers of governmental audit services to identify firms that are members.
- Provide information about the Center's activities to other governmental audit stakeholders.

.134 For more information about the GAQC visit gaqc.aicpa.org.

AICPA Center for Audit Quality

.135 The CAQ (formerly the Center for Public Company Audit Firms [CPCAF]) was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.136 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ visit thecaq.aicpa.org.

AICPA Industry Expert Panel—Health Care

.137 For information about the activities of the Health Care Industry Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_healthcare.htm.

Industry Web Sites

.138 The Internet covers a vast amount of information that may be valuable to auditors of health care organizations, including current industry trends and developments. Some of the more relevant sites for auditors with health care clients include those shown in the following table:

Organization	*Web Site*
Healthcare Financial Management Association	www.hfma.org
The Catholic Health Association of the United States	www.chausa.org
Federation of American Hospitals	www.americashospitals.com
Centers for Medicare and Medicaid Services	www.cms.hhs.gov
U.S. Department of Health and Human Services	www.hhs.gov

.139 This Audit Risk Alert replaces *Health Care Industry Developments—2006/07*.

.140 The Audit Risk Alert *Health Care Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to zdonahue@aicpa.org or write to:

Zachary T. Donahue, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

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Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to auditors and accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, Practice Bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+ and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
AICPA Governmental Audit Quality Center (GAQC)	Information and updates on the latest information relating to governmental auditing, particularly for audits performed under *Government Auditing Standards* and OMB Circular A-133	www.aicpa.org/GAQC
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov

(continued)

Web Site Name	*Content*	*Web Site*
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
General Printing Office Access	Provides links to search the Code of Federal Regulations, Federal Register, and Public Laws	www.access.gpo.gov
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov

[*The next page is 8121.*]

AAM Section 8040

Insurance Industry Developments—2007/08

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS

INSURANCE INDUSTRY DEVELOPMENTS—2007/08

This Audit Risk Alert is intended to provide auditors of financial statements of insurance industry entities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

William S. Boyd, CPA
Technical Manager
Accounting and Auditing Publications

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your insurance industry audits. This alert can also be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory 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 financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The insurance industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic, and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the entity's financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, GDP increased at an annual rate of 2.9 percent in 2006, consistent with the pace of growth experienced in 2005 when GDP increased by 3.1 percent. During the first quarter of 2007, GDP increased by an annual rate of only 0.6 percent. However, according to second quarter preliminary estimates, GDP increased at an annual rate of 4.0 percent.

.11 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, with an annual average rate of 4.6 percent representing approximately 7 million people. The 2006 rates represent the lowest annual rate and total number of jobless since 2000, according to the U.S. Department of Labor, Bureau of Labor Statistics. During the first half of 2007, the unemployment rate averaged 4.5 percent. These data further demonstrate the economic growth the United States has experienced since the beginning of 2006.

.12 After a period of rising rates during the first half of 2006, the Federal Reserve kept its target for the federal funds rate at 5.25 percent for 10 consecutive meetings (June 2006–August 2007). At that time, the Federal Reserve indicated future federal fund rate adjustments would likely depend upon the outlook for economic growth and inflation. Since its August 2007 meeting and in response to shaky financial market conditions, the Federal Reserve has taken several action steps. It announced that it would provide reserves as necessary through the open market to facilitate the orderly functioning of financial markets by promoting trading in the federal funds market at rates close to the 5.25 percent target rate. On August 17, 2007, it announced that financial market conditions had deteriorated and tighter credit conditions and increased uncertainty have the potential to restrain economic growth. Then at its September meeting, the Federal Reserve decided to lower its target for the federal funds rate 50 basis points to 4.75 percent citing increased uncertainty surrounding the economic outlook. The Federal Reserve also decided to decrease the discount rate 50 basis points to 5.25 percent to consistently keep the spread between the primary credit rate and the target federal funds rate at 50 basis points. At their October 31st meeting, the Federal Reserve decided to decrease the federal funds rate and discount rate 25 basis points to 4.50 percent and 5.0 percent, respectively. Auditors should remain alert to developments in the financial markets and how they may affect your audit engagements.

Industry Trends and Conditions

Life and Health Industry

General Overview

.13 Over the past several years, life insurance companies have focused on products meant to accumulate wealth. Individual annuities comprise the largest component of industry premiums and profits. Growth in individual annuities continues to be spurred on by attractive 12-month equity market returns, despite a fair amount of equity market volatility during 2007 and the continued demand for benefit guarantees, including those with "for life" provisions. However, as a result of an aging population, concerns about the viability of the social security system and the shifting responsibility for retirement funds from employers to employees, life insurance companies are increasing the focus on products that ensure that an individual will not outlive his or her wealth. The early versions of these products were minimum guarantee products offered with variable annuities. The more recent focus includes variations on those minimum guarantee products as well as products that focus on longevity, liquidity, and retirement medical or long-term care expenses. However, a historically lower level of general market interest rates may reduce the opportunity for growth in earnings and surplus of fixed interest life and annuity products. Life insurers have responded to these challenges by offering creative financial options in addition to traditional mortality, morbidity, and investment returns as a part of basic product offerings.

.14 Overall, sales of traditional life insurance policies have seen small growth levels for several years; however, universal life products continue strong growth, largely on the success of no-lapse guarantee products.

.15 Life insurers competing in the market place will continue to focus on distribution, products, and product innovation, including the addition of more risky policyholder option features, risk management of those product features, and efficient use of capital.

.16 The U.S. life insurance industry is generally well capitalized with healthy asset quality (subprime exposure has not been a significant life insurance industry issue to date). However, certain important elements that may affect an auditor's risk assessment include, but are not limited to, the following:

- Limited historical or market policyholder behavior experience to be utilized by companies in pricing and reserving for recently issued policyholder financial options continues to affect the comparability of valuation amongst competitors and the availability of reinsurance capacity. (Although, the availability of reinsurance is beginning to loosen; see further discussion on reinsurance in the sections of this alert entitled "NAIC Reinsurance Disclosure and Filing Requirements" and "Reinsurance Arrangements.")
- A statutory principles-based approach to reserving for no-lapse guarantees is still a few years away and, as a result, large excess reserving needs remain for many of these contracts, causing a need to fund this excess statutory strain. The auditor can refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), which provides guidance on obtaining and evaluating sufficient appropriate audit evidence to support significant accounting estimates. In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate and, based on that understanding, should use one or a combination of the approaches included in AU section 342.

.17 Hedging programs developed by insurers in recent years to manage exposures to policyholder financial options are beginning to be tested as a result of the more volatile equity markets in 2007. Increased volatility adds to the cost of hedging strategies, which could either reduce insurers' profitability or result in additional risk. The auditor can refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities Estimates* (AICPA, *Professional Standards*, vol. 1), which provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in securities.

Other-than-Temporary Impairments

.18 Much attention has been given to the topic of other-than-temporary impairments, particularly those that may arise from increases in general market interest rates or increases in sector spreads. Other-than-temporary impairments may significantly affect life insurers' earnings as interest rates increase, causing certain securities to be impaired. Companies may need to record an impairment even if a decision to sell has not been made. One factor in not recording an impairment is whether the company has the positive intent and ability to hold these impaired securities until recovery or maturity. There may be situations under which a change in facts and circumstances would allow companies to subsequently change their intent to hold the securities until forecasted recovery.

.19 Under Statutory Accounting Principles (SAP), determining whether impairment has occurred on an investment under the National Association of Insurance Commissioners' (NAIC) *Accounting Practices and Procedures Manual* is similar to generally accepted accounting principles (GAAP). 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 (SSAPs). Differences do arise between GAAP and SAP regarding the timing of an impairment loss for securities subject to Emerging Issues Task Force (EITF) Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*. Additionally, under SAP, impairments related to interest rates or sector spreads are recorded when there is intent to sell the related security.

.20 The NAIC Manual requires 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. In their winter 2006 meeting, the NAIC's Emerging Accounting Issues Working Group (EAIWG) issued Interpretation 06-07, *Definition of Phrase "Other Than Temporary,"* which incorporates portions of Financial Accounting Standards Board (FASB) Staff Position (FSP) FAS 115-1 and 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (paragraphs 6, 7, and 11), rejects other concepts (paragraphs 1–5, 8–10, 12–15, and 19), and adopts certain aspects of the consensus reached in EAIWG Interpretation 02-07, *Definition of "Other Than Temporary."*

Guarantees and Other Developments

.21 Variable annuity products that contain minimum guaranteed death benefits (MGDBs) or guaranteed minimum income benefits (GMIBs) pose additional consideration, which include the following:

- 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 is not sufficient to support the level of benefit payment.
- GAAP and SAP may require insurers to establish reserves for variable annuity guarantees on these products, thereby placing strain on capital strength.

.22 The NAIC Risk Based Capital C3 Phase II initiative requires cash-flow testing for annuities or other products with exposure to interest-rate risks. Interest-rate risk may increase if there is a duration mismatch between assets and liabilities. Testing includes multiple scenarios with various interest rate fluctuations to determine whether reserves are adequate. This testing may cause some life insurers to increase their capital requirements for interest-sensitive products.

.23 Companies that issue universal life insurance with no-lapse guarantee mortality features are subject to the provisions of Statement of Position (SOP) 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts* (AICPA, *Technical Practice Aids*, ACC sec. 10,870), and should establish liabilities in addition to account balances if amounts assessed each period for the feature are expected to result in profits in earlier years followed by losses in subsequent years.

.24 SOP 03-1 contains guidance for accounting for MGDBs, GMIBs, and no-lapse guarantee features. These features are also addressed in FSP FAS 97-1, *Situations in Which Paragraphs 17(b) and 20 of 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," *Permit or Require the Accrual of an Unearned Revenue Liability*, and in Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 6300.08, "Definition of an Insurance Benefit Feature" (AICPA, *Technical Practice Aids*). Management should be familiar with all of these pronouncements in applying the guidance in SOP 03-1. Auditors should also gain an understanding of these pronouncements, depending upon the circumstances at their clients.

Regulation XXX/AXXX Considerations

.25 State insurance regulators adopted regulation XXX in 2000 to provide for the cost of renewal guarantees in term insurance products. Later, universal life no-lapse guarantees based on the payment of minimum premiums were also covered by this regulation. In 2003, state regulators adopted AXXX, intended to capture secondary guarantees covered by other policy designs. It states, "Reserves need to be established for the guarantees provided by a policy." In many cases, life insurers have transferred the reserve requirements under these regulations to offshore reinsurance companies. As a result of significant growth in term insurance renewal guarantees and universal life no-lapse guarantees, some knowledgeable parties predict that the availability and cost of bank letters of credit backing offshore reinsurance could be severely affected within the intermediate future. Also, subsequent interpretation of these new regulations may result in some insurers being required to post additional statutory reserves to cover no-lapse guarantees.

.26 The NAIC formally adopted a change to AXXX that affects policies written after the effective date of July 1, 2005. It is anticipated that the change to AXXX will result in higher capital and reserve requirements, price increases for universal life policies with secondary guarantees, and revised product designs. Some life insurers are expected to use affiliated reinsurance relationships to cede these additional reserves, thereby decreasing the effect on earnings and return on equity. The change to AXXX will be in effect for two years, at which point it is expected that a principles-based approach for determining statutory reserves will be in place. On June 1, 2006, the NAIC legal staff ruled that state insurance commissioners may include lapse rates in their interpretation of Actuarial Guideline 38, *The Application of the Valuation of Life Insurance Policies Model Regulation*, when they formulate reserve requirements, and several key regulators are on record of supporting this action. This ruling may allow insurers to hold lower reserves while industry regulators and actuarial groups continue to work on a permanent rule to adopt principle-based reserving practices for statutory purposes. However, the timing and certainty of principles-based practices are not definite and probably will not occur within the upcoming audit year.

Property and Liability Industry

.27 The U.S. property and casualty insurance industry reported strong performance in the first half of 2007; however, certain concerns exist, as discussed in the next section of this alert. The industry combined ratio was 92.7 percent[1] for the first half of 2007, with an annualized statutory return on average surplus of 13.1 percent for the year, according to the Insurance Information Institute (III). Insurance companies were affected by record catastrophe losses in 2005; however, reduced hurricane activity during 2006 and 2007 has contributed to favorable 2007 operating results, resulting in restored levels of policyholder surplus.[2] According to the Insurance Services Office, the industry consolidated surplus increased by $26.6 billion or 5.5 percent in the first half of 2007 from its year-end 2006 level, to $512.8 billion, marking the first time that consolidated surplus exceeded the half trillion dollar mark.

.28 However, the industry continues to face a number of ongoing challenges including, but not limited to, the following:

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[1] A combined ratio of 92.7 means that for every dollar of premium income that insurers earned during the first half of 2007, 92.7 cents exited in the form of claims payments, claims reserves, and expenses. The remaining 7.3 cents is underwriting profit.

[2] Policyholder surplus is a measure of claims paying capacity or capital.

- The possibility of above average catastrophe losses due to variable weather conditions and terrorist activity
- A continued soft market for rates
- Slow growth environment, driven in part by lower loss costs, that can lead to price competition
- Margin pressures as regulators limit insurers' recovery of the costs of catastrophes or reinsurance

Commercial Market

Property and Causality

.29 Continued strong profitability has led to increasingly stiff competition in the property and casualty market. Coverage is plentiful, and policies are being sold at low prices, reflecting the supply surplus in a buyers' market. Average premium rates for all commercial accounts decreased 11.8 percent during the second quarter of 2007, according to survey data released by The Council of Insurance Agents and Brokers. As premium prices fall and underwriters become more eager for new business, insurers are beginning to be more aggressive in pricing and more liberal with policy terms.

.30 One of the few exceptions to this pricing pressure is property insurance in catastrophe-prone areas. This is due in large part to court decisions in Mississippi and Louisiana, which have put upward pressure on prices and limited availability. However, the industry has seen a leveling of property catastrophe reinsurance as competition increases in combination with limited exposure since 2005.

.31 Realized investment gains have offset the declines in underwriting results, which has allowed companies to maintain strong levels of profitability. Because of the industry's conservative leanings towards investments, the turmoil in the subprime mortgage market has had limited impact on investments. Auditors would be advised to pay special attention to these investments, especially in light of the new fair value standards, which are discussed in detail later in this alert.

.32 In response to increased competitive market forces, an auditor can evaluate if the client has implemented liberal policy terms, added unattractive clients, or expanded its product mix. Is product classification and valuation appropriate, considering these management assertions may become more complex if policy terms are altered? Unattractive clientele increase the risk of loss surrounding potential claim payouts, which can affect valuation complexity. Furthermore, if new products have been rapidly developed in response to changing market conditions, an auditor may consider if there has been proper management review of long-term product strategies. A company's product mix may have a significant effect on the variability of loss reserves. New products can add to the subjectivity of the loss-reserving process because of a company's lack of experience with the new product and relative lack of relevant historical data.

.33 An auditor can refer to AU section 342, which states that the auditor's objective when evaluating accounting estimates is to obtain sufficient appropriate audit evidence to provide reasonable assurance that:

- All accounting estimates that could be material to the financial statements have been developed.
- Those accounting estimates are reasonable in the circumstances.
- The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.

Automobile Insurance

.34 The III estimates that the average premium expenditure will drop by one half percent in 2007, which would be the first drop in the average premium since 1999. Reductions are possibly due to decreasing claim frequency coupled with only modest increases in claim severity throughout 2006 (the last period for which data was available). In 2006, as compared with 2005, claim frequency decreased between 3 and 5 percent, and the average cost per claim, which includes the cost of medical care and property damage, only increased from 2 to 4 percent. The increase in cost per claim is modest despite the ever increasing costs of medical care, which significantly affects automobile insurance pricing. Changing demographics of the U.S. population are also contributing to cost reductions because millions of baby boomers are now considered to be in what insurers consider their safest driving years.

.35 The auditor can evaluate the effect of the aforementioned variables on a client's operations. Evidence or expectations of increased competition, market saturation, or declining demand may lead to loosened underwriting standards and increased margin pressure. Additionally, implementation issues could surround newly implemented underwriting technology. AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), describes the objectives and components of internal control and explains how an auditor should consider internal control in planning and performing an audit. Among other matters, the auditor can evaluate client operational internal controls, including, but not limited to, the sufficiency of controls surrounding IT advances and applicable manual procedures.

Potential Audit Risk Area—Claims Expense and Loss Reserves

.36 *Claim and claim expense payments*. In most cases, claim and claim expense payments originate with evidence of loss that may include signed proofs of loss, releases, medical bills, repair bills or estimates of repair costs, or invoices for fees of independent adjusters (for reinsurers, this evidence may be a notice of loss or broker's advice). When these documents are received, they are reviewed and analyzed for accuracy, consistency, and coverage under the associated policy before payment is authorized.

.37 Liabilities for the cost of unpaid claims, including estimates of the cost of claims incurred but not reported, are accrued when insured events occur. Under GAAP, the liability for unpaid claims is based on the estimated ultimate cost of settling the claims (that is, the total payments expected to be made) and should include the effects of inflation and other social and economic factors.

.38 Under GAAP, consideration should be given to the guidance in FASB Statement No. 5, *Accounting for Contingencies*; FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*; FASB Interpretation No. (FIN) 14, *Reasonable Estimation of the Amount of a Loss—an interpretation of FASB Statement No. 5*; SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids,* ACC sec. 10,640); SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* (as amended by SOP 01-5), (AICPA, *Technical Practice Aids,* ACC sec. 10,630); and the Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 87, *Contingency Disclosures on Property/Casualty Insurance Reserves for Unpaid Claim Costs*, which governs accounting and reporting if property liability loss reserves qualify as loss contingencies. Additional guidance can be found in SEC SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies*, and SEC Financial Reporting Release No. 20, *Rules and Guide for Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters* (SEC Release No. 6559, vol. 49 of the Federal Register, page 47,594).

.39 Under SAP, SSAP No. 55, *Unpaid Claims, Losses and Loss Adjustment Expenses*, provides that the liability for unpaid losses and loss adjustment expenses shall be based upon the estimated cost of settling claims incurred (including the effects of inflation and other social and economic factors), using past experience adjusted for current trends and any other factors that would modify past experience. SSAP No. 62, *Property and Casualty Reinsurance*, and SSAP No. 65, *Property and Casualty Contracts*, provide guidance on reinsurance accounting and accounting for contracts having certain features, such as claims-made policies and high deductible policies, respectively.

.40 *Auditing Considerations*. Due to the increased number and complexity of transactions surrounding claims and claim expenses, especially following a catastrophic year such as 2005, inherent risk surrounding the recording and payout of claims can increase. Auditors would be advised to evaluate their client's response and adherence to criteria and related internal controls surrounding expenses.

.41 The identification of changes surrounding valuation variables and consideration of their effect on losses are critical audit steps. The evaluation of these factors includes the involvement of specialists and input from various operating departments within the company, such as marketing, underwriting, actuarial, reinsurance, and legal. Readers should remember that losses are only accrued for events that have occurred; catastrophe reserves are not allowed in anticipation of future events.

.42 AU section 342 states that the auditor should obtain an understanding of how management developed the accounting estimates included in the financial statements. Claims expense and loss reserve estimates are significant variables on an insurance company's financial statements. Accordingly, regardless of the approach used to audit claims expense and loss reserve estimates, the auditor should gain an understanding of how management develops estimates. Additionally, Chapter 4 and Appendix A of the AICPA Audit and Accounting Guide *Property and Liability Insurance Companies*, which incorporates SOP 92-4, *Auditing Insurance Entities' Loss Reserves* (AICPA, *Technical Practice Aids,* AUD sec. 14,230), is an additional source of guidance.

.43 Auditors can also refer to AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), as well as noting current practitioner prohibitions and restrictions that exist related to the performance of nonaudit services for audit clients, including certain actuarial services. Practitioners should be aware of and comply with these prohibitions and restrictions, including the AICPA, SEC, and Public Company Accounting Oversight Board (PCAOB) independence rules; new NAIC rules describing qualifications of an independent CPA included in the Annual Financial Reporting Model Regulation (Model Audit Rule) effective for 2010 statutory audits; and rules passed by the U.S. Government Accountability Office, state licensing boards, and others.

Potential Audit Risk Area—Reinsurance Recoverables

.44 FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, provides guidance on the recording and reporting of recoveries of losses that are reinsured. Consideration should be given to the terms of the reinsurance agreements and the creditworthiness of the reinsurer. Significant payment terms may be material to liquidity and required capital levels. See the detailed discussion of reinsurance in the "NAIC Reinsurance Disclosure and Filing Requirements" and "Reinsurance Arrangements" sections of this alert.

.45 *Auditing Considerations*. AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), requires auditors to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. A significant consideration in the auditor's evaluation of an insurance company's ability to continue as a going concern is whether the company complies with regulatory risk-based capital requirements. SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), requires that auditors communicate with those charged with governance events or conditions that lead the auditor to believe there is substantial doubt about the entity's ability to continue as a going concern.

Regulatory Developments

Recent Statutory Accounting Principles

.46 The NAIC continues to create and clarify statutory accounting guidance for insurance enterprises through its ongoing maintenance process. The most recent *Accounting Practices and Procedures Manual* (manual) was published by the NAIC as of March 2007. For manual subscribers, modifications made subsequent to the publication of the manual are available from the NAIC Web site at www.naic.org. Insurance laws and regulations of the state insurance departments require insurance companies domiciled in those states to comply with the guidance provided in the manual, except as otherwise prescribed or permitted by state law or regulation.

.47 The 2007 manual contains three new SSAPs, which were adopted during 2006:

1. SSAP No. 94, *Accounting for Transferable State Tax Credits*, requires that transferable state tax credits acquired be recorded at cost on the balance sheet, gross of any related state tax liabilities, and reported as other than invested assets. SSAP No. 94 also provides guidance on the accounting for redemption of state tax credits, gains and losses recognized on transferable tax credits, and impairment recognition for a transferable state tax credit asset. SSAP No. 94 is effective for reporting periods ending on or after December 31, 2006.

2. SSAP No. 95, *Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions*, adopts the guidance in FASB Statement No. 153, *Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29*. SSAP No. 95 allows for an exception to measuring exchanges of nonmonetary assets at fair value when the nonmonetary exchange of similar productive assets does not have commercial substance. SSAP No. 95 is effective as of January 1, 2007.

3. SSAP No. 96, *Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties*, requires that the terms of transactions between related parties be defined in a written agreement and that the agreement provides for timely settlement of amounts owed, including specified due dates. Any amounts owed to the reporting entity over 90 days past the due date or where the due date is not specifically addressed in a written agreement should be nonadmitted for statutory accounting purposes, unless specifically addressed by other SSAPs. SSAP No. 96 is effective for reporting periods ending on or after December 31, 2007.

.48 The NAIC has continued its ongoing discussion on proposed revisions to SSAP No. 88, *Investments in Subsidiary, Controlled and Affiliated Entities, a Replacement of SSAP No. 46*, as a result of numerous questions raised by regulators, industry representatives, and members of the accounting profession regarding its implementation. In early 2007, the NAIC drafted SSAP No. 97, *Investments in Subsidiary, Controlled and Affiliated Entities—A Replacement of SSAP No. 88,* which is a proposed replacement to SSAP No. 88. The significant changes included in SSAP No. 97 currently being discussed include the following:

- Combined audited financial statements will be allowed in complying with requirements under SSAP No. 88 that subsidiary, controlled, or affiliated entities (SCA) be audited.
- Foreign Security Control Agreement entities will be allowed to provide audited financial statements on a foreign-GAAP basis, with an audited footnote reconciliation to U.S. GAAP, in complying with the audit requirement under SSAP No. 88.
- The "look-through" approach will be allowed, which permits a company to admit the value of a downstream holding company in certain circumstances.
- Language was added to clarify that the carrying value of an investment in an SCA should be reduced by the issuer's value of preferred stock or surplus notes.

.49 If adopted, SSAP No. 97 would be effective for reporting periods on or after December 31, 2007.

.50 Additionally, 11 new interpretations were adopted during 2006 and incorporated into the revised manual. As of the September 2007 NAIC SAP Working Group meeting, two new interpretations have been adopted that are effective for 2007. Additionally, several nonsubstantive revisions to various SSAPs and manual appendixes were made during 2006 and 2007 by the NAIC.

NAIC Reinsurance Disclosure and Filing Requirements

.51 Reinsurance disclosures were added to SSAP No. 62 effective for 2006 that consist of interrogatories directed at disclosing finite reinsurance situations. These reinsurance interrogatory disclosures are required to be included as accompanying supplemental schedules to the annual audited financial statements of property and casualty insurance companies beginning in 2006. These disclosures, which are also included as interrogatories in the annual statement, require detailed information about specific ceded reinsurance contracts. Reinsurance issues have taken center stage at the NAIC as regulators react to the former New York state attorney general's investigations of finite reinsurance, as well as allegations that undisclosed side agreements between ceding and assuming companies contributed to some property-casualty insolvencies. During 2005, the NAIC's SAP Working Group exposed updates to SSAP No. 62 that would expand disclosure requirements related to ceded reinsurance. These disclosures, which are also included as interrogatories in the annual statement, require detailed information about specific ceded reinsurance contracts.

.52 The new disclosures were included in response to interrogatories in the 2005 annual statement filings. During 2006, the reinsurance interrogatory requirement was further amended by limiting the reinsurance contracts to be included in this interrogatory to those contracts having an underwriting effect, written premium ceded, or loss and loss expense reserves ceded greater than 5.0 percent of the prior year surplus, effective for 2007. For 2006, the current limitation of 3.0 percent of surplus remains in effect for 2006 reporting. Beginning in 2006, these new reinsurance interrogatories are required to be included as accompanying supplemental schedules to the annual audited financial statements of insurance companies. As discussed briefly in this alert, during the 2006 winter NAIC meeting, the SAP Working Group adopted this proposed change to narrow the scope of disclosure. For the supplemental schedule to the audited financial statements, the scope of these disclosures is limited to reinsurance contracts entered into, renewed, or amended on or after January 1, 1994. The disclosures will be included in the 2006 audited financial statements for the first time. This limitation to post-1994 contracts does not apply to the disclosures in the annual statement interrogatories. These new financial statement disclosures include:

- Whether any quota share reinsurance contracts include provisions that would limit the reinsurer's losses below the stated quota share percentage (for example, a deductible, loss ratio corridor, loss cap, aggregate limits, or similar provisions). If such contracts exist, management is required to disclose whether the limiting provisions have had an effect on ceded losses.
- Whether any significant contracts contain any of six specific contractual features often associated with finite reinsurance arrangements.[3]
- Whether there are any significant contracts with related parties, other than approved pooling arrangements.
- Whether any contracts are accounted for as reinsurance under SAP and as deposits under GAAP, or vice versa, and, if so, why.

.53 For contracts meeting the first three bulleted criteria, management is further required to disclose a summary of the reinsurance contract terms, a brief discussion of management's principal objectives in entering into the agreement, including the economic purpose to be achieved, and the aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

[3] The six specific contractual features are (1) contact terms greater than two years when the contract is noncancelable by the reporting entity, (2) cancellation provisions that trigger an obligation on the reporting entity to enter into a new reinsurance agreement with the reinsurer, (3) aggregate stop loss reinsurance coverage, (4) an unconditional or unilateral right by either party to commute the treaty, (5) a provision permitting reporting or payment of losses less frequently than on a quarterly basis, and (6) any features designed to delay timely reimbursement to the ceding entity.

SSAP No. 9 Considerations

.54 SSAP No. 9, *Subsequent Events*, which was based on AU Section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), defines subsequent events and establishes criteria for recording such events in the financial statements or disclosing them in the notes to the financial statements. All information that becomes available prior to the issuance of the financial statements relating to a material Type 1 subsequent event (currently defined in SSAP No. 9 as "events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements") shall used by management in determining the related accounting estimate.

.55 At the Fall 2007 NAIC meeting, the NAIC SAP Working Group adopted revisions to paragraph 13 of SSAP No. 55 in response to the issue of whether accounting judgments and estimates inherent in the preparation of statutory-basis financial statements should be updated to reflect Type 1 subsequent events occurring between the annual statement filing date and the issuance of the audited statutory-basis financial statements. This amendment clarifies that liabilities for unpaid claims, losses, and loss adjustment expenses within the scope of SSAP No. 55 are not expected to be reestimated. Rather, additional information that is obtained after the submission of the annual statement, which is not indicative of an error in the estimation process, is considered part of the continuous review process and should be reflected in the statement of operations in the period the change becomes known.

.56 Readers should be aware that this guidance applies only to unpaid claims, losses, and loss adjustment expenses within the scope of SSAP No. 55, and that to be compliant with SSAP No. 9 as currently written, companies will need to have a process in place to update other judgments and estimates for Type 1 subsequent events occurring between the annual statement filing date and the issuance of the audited statutory-basis financial statements.

Section 11 of the NAIC Model Audit Rule & AICPA Statutory Framework

.57 Section 11 of the NAIC Model Audit Rule requires that, in addition to the annual audited financial statements, each insurer provide the insurance department with a written report prepared by the accountant describing significant deficiencies in the insurer's internal control structure noted by the accountant during the audit. The current NAIC Model Audit Rule specifically references SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, for definitions and guidance on the reporting requirements. If significant deficiencies are noted, the written report should be filed annually by the insurer with the insurance department generally within 60 days following the filing of the annual audited financial statements. The insurer is required to provide a description of remedial actions taken or proposed to correct significant deficiencies, if the actions are not described in the auditor's report.[4]

.58 During the summer of 2006, the AICPA Auditing Standards Board (ASB) issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which replaced SAS No. 60. SAS No. 112 is effective for periods ending on or after December 15, 2006. SAS No. 112 conformed the definitions of significant deficiency and material weakness to those in PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements*, prior to it being superseded.

.59 The AICPA and PCAOB internal control related definitions and guidance for evaluating control deficiencies were consistent until May 2007, when the PCAOB issued Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated With An Audit of Financial Statements* (AICPA,

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[4] State laws may vary, and thus it is necessary that companies and their auditors verify reporting requirements by reference to domiciliary state laws and regulations. For example, some states require the filing of the SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended, report at the same time the audited financial statements are filed.

PCAOB Standards and Related Rules, Rules of the Board, "Standards"). The ASB has a project underway to revise AU section 325, as well as AT Section 501, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1), in response to the issuance of Auditing Standard No. 5 and the International Auditing and Assurance Standards Board's (IAASB) project related to this topic. However, the ASB revision of the standard is not expected until 2008, when the IAASB will have made further progress on its proposed International Standard on Auditing (ISA).

.60 For year-end 2007 audits, SAS No. 112 will not be revised to incorporate the revised definition of *significant deficiency* in Auditing Standard No. 5; the definition under SAS No. 112 should be used in complying with Section 11 of the NAIC Model Audit Rule.

.61 Due to changes over the past several years in AICPA and PCAOB auditing standards relating to communication of internal control matters noted in an audit, a resulting increase in the identification of deficiencies in internal control over financial reporting at many insurance companies, insurers have sought additional guidance on reporting internal control related matters to insurance regulators. The publication, *A Statutory Framework for Reporting Significant Deficiencies and Material Weaknesses in Internal Control to Insurance Regulators* (Statutory Framework), outlines a suggested framework for auditors to follow when reporting internal control deficiencies related to financial reporting identified during the course of an annual audit of statutory financial statements in accordance with Section 11 of the Model Rule and AICPA auditing standard (that is, SAS No. 112[5]) and can be found on the AICPA Web site at: www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_insurance.htm.

Terrorism Insurance Developments

.62 The market for terrorism risk insurance was severely disrupted by the events of September 11, 2001. Those events resulted in reinsurers no longer covering terrorism risk or offering coverage only at very high rates. On November 26, 2002, the president signed Terrorism Risk Insurance Act (TRIA) into law. TRIA established a temporary federal program of shared public and private compensation for insured commercial property and casualty losses resulting from acts of terrorism.

.63 Accordingly, terrorism exclusions on existing insurance policies were removed, and all policyholders had the ability to secure coverage for terrorism risk through mandatory offer requirements placed on insurers. TRIA, as amended in 2005, placed the federal government temporarily in the terrorism risk reinsurance business because the program was written to sunset on December 31, 2007. With expiration imminent, Congress is considering extending TRIA past December 31, 2007. The House of Representatives passed legislation in September 2007 to extend it and, on October 17, 2007, the Senate Banking Committee voted to pass their version out of committee. However, the timing of a full Senate vote and any necessary reconciliation of the two bills is uncertain at this writing and should be monitored by auditors. A summary of the 2005 amendments, which are currently in effect for 2007, are discussed in the following paragraphs of this alert.

.64 The 2005 amendments placed limits on the lines of business that can participate in the Terrorism Risk Insurance Program (TRIP), adding to existing exclusions (medical malpractice, reinsurance, life and health, crop, financial guaranty, and flood) the following lines: commercial auto, burglary and theft, surety, professional liability (as distinguished from directors and officers liability coverage), and farm owners multiple peril coverages. Thus, these lines are no longer required to participate in TRIP.

.65 Under the original program, once an insurer suffers a loss equal to its deductible, the U.S. Treasury covers 90 percent of the losses above the deductible. The insurer's deductible increases over the life of the

[5] SAS No. 112 specifies that, for its purposes, references to GAAP include a comprehensive basis of accounting other than GAAP.

program. In 2004, the deductible was equal to 10 percent and increased to 15 percent of direct-earned premium in 2005. TRIA also provides the U.S. Treasury with the authority to recoup federal payments via policyholder surcharges. The maximum amount of any potential policyholder surcharge that can be imposed is 3.0 percent per year. A summary of the major changes as a result of the amendments is as follows:

- The amendments increased the insurer deductible for the 2007 program year to 20 percent of the prior calendar year direct-earned premiums (the insurer deductible for the 2005 and 2006 program years were 15 percent and 17.5 percent of the prior program year's direct-earned premium, respectively).
- The amendments increased the industry aggregate retention amount for the 2007 program year to the lesser of $27.5 billion and the aggregate amount of insured losses for all insurers for the 2007 program year (the industry aggregate retention for the 2005 program year was $15 billion and for 2006, $25 billion).
- For the 2007 program year, the amendments established a program trigger of $100 million in aggregate industry insured losses resulting from certified acts occurring during the 2007 program year. (For the 2006 program year, the trigger was $50 million in aggregate industry insured losses resulting from certified acts occurring after March 31, 2006.)
- Subject to the 2007 program trigger, the amendments maintain the federal share of compensation under the program at 90 percent of the portion of the amount of insured losses exceeding the applicable deductible for the 2007 program year, while reducing the federal share to 85 percent of the portion of the amount of insured losses exceeding the applicable deductible for the 2007 program year.
- The 2005 amendments maintained the annual cap on insured losses at $100 billion for both the 2006 and 2007 program years.

.66 Auditors should remain alert to developments in this area and, depending on what laws are in place, assess effects to disclosures, liability accruals, and subsequent events for 2007 fiscal year ends. The concern is that, in the absence of TRIA, it is likely that terrorism exclusions will again become the norm for commercial line policies and that private reinsurers are not likely to fill the reinsurance capacity void if TRIA is not extended after December 31, 2007.

.67 The NAIC members have adopted a model bulletin to provide guidance to insurers related to rate filings and policy language that state regulators would find acceptable to protect U.S. businesses from acts of terrorism. They have also developed Model Disclosure Forms 1 and 2 to assist insurers in complying with TRIA. The model disclosure forms may be used and modified by insurers to meet their obligation under the rules, provide policyholders with the status of current coverage, and, in some cases, make a selection regarding future insurance coverage for acts of terrorism. Insurers must comply with state law and TRIA and are encouraged to review the disclosure forms in light of their current policy language, state legal requirements, and the provisions of the TRIA amendments and TRIP.

National Flood Insurance Program

.68 The National Flood Insurance Act of 1968 created the National Flood Insurance Program (NFIP) as this type of insurance was unavailable from the private insurance markets. NFIP was overwhelmed by claims from the 2004 and 2005 hurricane season and Congress was forced to raise the program's borrowing authority to pay claims. It became apparent that NFIP was in need of reforms in order to remain viable and to provide consumers the desired protection. Additionally, due to difficulty in the marketplace for consumers to obtain windstorm coverage and controversial decisions regarding coverage of claims from Hurricanes Rita and Katrina, there has been a move to have NFIP offer both flood and windstorm coverage. A House bill has passed to reform the program and offer windstorm coverage. The Senate Banking Committee will vote in October 2007 on its own legislative version to reform the NFIP; however, it does not propose an expansion of the program to the offering of windstorm coverage. Auditors should monitor developments in this area and, depending on what laws are passed, assess effects to disclosures, liability accruals, and subsequent events for 2007 fiscal year ends.

Reminder—Consideration of the Examiners Handbook

.69 The Model Audit Rule states that auditors shall consider the procedures in the NAIC *Financial Condition Examiners Handbook* (Examiners Handbook) in the conduct of the audit as the independent certified public accountant deems necessary. Although the AICPA supports increased communication with regulators and a better understanding of the financial examination process and procedures, it does not require auditors to perform procedures from the Examiners Handbook that they would not have otherwise performed as part of a generally accepted auditing standards (GAAS) audit. This provision of the Model Audit Rule places emphasis on giving consideration to the procedures contained in the Examiners Handbook. In planning the audit, auditors may consider incorporating into their planning documentation that they have given consideration to the Examiners Handbook procedures as they deemed necessary. In the conduct of financial examinations, examiners review, use, and rely upon the audit working papers.

Reminder—Actuarial Data Integrity

.70 The NAIC *Annual Statement Instructions: Property and Casualty* requires coordination among the auditor, the appointed actuary, and management and may potentially require additional procedures for the auditor related to claims loss and loss adjustment expense data. Section 9 of the instructions, "Scope of Examination and Report of Independent Certified Public Accountant," states:

> The insurer shall also require that the independent certified public accountant subject the data used by the appointed actuary to testing procedures. The auditor is required to determine what historical data and methods have been used by management in developing the loss reserve estimate and whether he or she will rely on the same data or other statistical data in evaluating the reasonableness of the loss reserve estimate. After identifying the relevant data, the auditor should obtain an understanding of the controls related to the completeness, accuracy, and classification of loss data and perform testing as (to) the understanding of the controls related to the completeness, accuracy, and classification of loss data, and perform (other) testing (as) the auditor deems appropriate. Through inquiry of the appointed actuary, the auditor should obtain an understanding of the data identified by the appointed actuary as significant. It is recognized that there will be instances when data identified by the appointed actuary as significant to his or her reserve projections would not otherwise have been tested as part of the audit, and separate testing would be required. Unless otherwise agreed among the appointed actuary, management and the auditor, the scope of the work performed by the auditor in testing the claims data in the course of the audit would be sufficient to determine whether the data tested is fairly stated in all material respects in relation to the statutory financial statements taken as a whole. The auditing procedures should be applied to the claim loss and defense and cost containment expense data used by the appointed actuary and would be applied to activity that occurred in the current calendar year (for example, tests of payments on claims paid during the current calendar year).

.71 There may be circumstances in which data deemed significant by the appointed actuary is not included as part of the statutory financial statement audit. This may result in a need for additional testing outside the scope of the statutory audit to comply with the NAIC data integrity requirements. The conclusion regarding the need for the auditor to perform additional procedures should be agreed with management, after discussion with the appointed actuary. Additional procedures needed to fulfill the NAIC requirement for data integrity could be accomplished through an Agreed-Upon Procedures report, performed in accordance with AICPA professional standards. In October 2004, the American Academy of Actuaries Committee on Property & Liability Financial Reporting published a paper on this area titled *Data Testing Requirement in 2004 P/C Annual Statement Instructions: Guidance For Actuaries Signing Statements of Actuarial Opinions on Loss and Loss Expense Reserves*. The paper can be found on the American Academy of Actuaries Web site at www.actuary.org.

Reminder—Access to CPA Audit Documentation

.72 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.

.73 Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," in AU section 9339, *Audit Documentation: Auditing Interpretations of Section 339* (AICPA, *Professional Standards*, vol. 1, AU sec. 9339.01–.15), addresses the responsibilities of an auditor when a regulator requests access to audit documentation. Auditors should note that PCAOB Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), supersedes AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), for audits of public companies and other issuers.

.74 The AICPA's task force on NAIC matters has worked actively with subgroups consisting of designated regulators and NAIC representatives to pursue ways to increase the examiners' reliance upon the statutory audit and use of underlying audit documentation. Suggested protocols were forwarded to the Financial Examiners Handbook Technical Group for consideration of possible revisions to the Examiners Handbook and have been incorporated into the handbook.

.75 The AICPA NAIC Task Force helped to establish the four-step process to provide a protocol for financial examiners who are having difficulty pursuing a resolution of (1) questions with respect to a firm's individual engagement to perform a statutory audit, (2) difficulties in gaining access to working papers, or (3) the regulator concerns about the work performed by the CPA. If a financial examiner determines that an additional response is required, after informing appropriate management, the financial examiner would contact the following individuals in this suggested order, as needed:

1. The engagement partner
2. The designated national firm representative (included on the NAIC Web site)
3. Chair of the insurer's audit committee
4. State board of accountancy, ethics (or quality review) committee, or other regulatory bodies deemed appropriate

.76 Firms or individual practitioners performing statutory audits of regulated insurance entities that wish to designate a national firm representative and have not already done so should contact NAIC representatives at (816) 783-8006 or (816) 783-8132.

Audit and Accounting Issues and Developments

Reinsurance Arrangements

Accounting Considerations

.77 During the past several years, the New York attorney general's office, the SEC, several state insurance departments, and other governmental and regulatory bodies have been investigating the use of finite risk reinsurance contracts and whether companies have properly accounted for these products. Several companies have restated previously issued financial statements to change their accounting for reinsurance arrangements and some insurance company executives have been indicted or are the subject of enforcement actions. Reinsurance accounting and reporting—in particular, the question of what constitutes an acceptable transfer of risk and whether side agreements having accounting consequences exist between ceding and assuming companies—continue to be important issues requiring careful analysis.

.78 FASB Statement No. 113 and FASB EITF Topic No. D-34, "*Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113*," continue to be the primary sources of guidance used to determine whether a contract transfers risk and meets the conditions for reinsurance accounting. In May 2006, the FASB issued an invitation to comment on *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*, which applies to policyholders, insurers, and reinsurers, with a comment deadline of August 2006. The invitation to comment asked for comments from buyers and sellers of insurance and reinsurance contracts and the users of their financial statements about the possible bifurcation of those contracts.

.79 At its December 6, 2006 meeting, the FASB discussed the comment letters received on the FASB Invitation to Comment, *Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting*, and how to proceed with the risk transfer project. The board directed the staff to focus on the following items to enhance the current risk transfer guidance:

- Propose editorial changes, principally to FASB Statement No. 113, to clarify the minimum level of insurance risk transfer required for a contract to be accounted for as reinsurance under the statement.
- Develop improved insurance and reinsurance disclosure requirements highlighting (*a*) how and why the entity uses insurance and reinsurance, (*b*) how those contracts are accounted for, (*c*) any risk-limiting features included in those contracts, and (*d*) the effect of those contracts on the financial statements.
- Clarify that noninsurance company policyholders must evaluate whether the insurance contracts they hold transfer significant insurance risk using criteria like those for reinsurance contracts in FASB Statement No. 113.

.80 The FASB plans to issue an exposure draft in the fourth quarter of 2007 that will clarify the level of insurance risk transfer required for a contract to be accounted for as reinsurance, clarify that noninsurance entity policyholders must evaluate whether contracts they hold transfer significant insurance risk, and improve insurance and reinsurance disclosure requirements. Information on the status of this project can be found on the FASB's Web site at www.fasb.org/project/insurance_risk_transfer.shtml.

.81 EITF Issue No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises;" EITF Issue No. 93-14, "Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises;" and EITF Topic No. D-35, FASB Staff Views on Issue No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises," represent guidance on required accruals when future rights and obligations under a multiple-year contract change based on loss experience to date.

.82 SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk* (AICPA, *Technical Practice Aids*, ACC sec. 10,760), 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 whether the contract transfers:

- Only significant timing risk
- Only significant underwriting risk
- Neither significant timing nor underwriting risk
- An indeterminate risk

.83 Other accounting standards continue to have implications for transactions involving reinsurance arrangements. For example, FIN 46(R), *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*, may necessitate counterparties to reinsurance arrangements placed in certain kinds of structures or entities (for example, catastrophe bond structures) to consider consolidation of these structures or entities. In addition, certain reinsurance contracts may contain embedded derivatives that require accounting in accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Auditors may want to review FASB Statement No. 133 Implementation Issue No. B36, *Embedded Derivatives: Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments*, which addresses embedded derivatives in modified coinsurance and coinsurance with funds-withheld arrangements and other contracts with similar provisions where, for example, a return under the contract is calculated based on a referenced pool of assets. This implementation issue, which was last updated in June 2006, can be accessed on the FASB Web site at www.fasb.org/derivatives/issuindex.shtml.

.84 As products become more advanced and complex, careful consideration is required to determine whether 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 and to determine proper accruals under FASB Statement No. 60, FASB Statement No. 113, and EITF Issue No. 93-6 (for example, whether premium recognition should be accelerated as reinsurance coverage is exhausted). Auditors may need to assess whether companies have adequate internal controls to identify and analyze complex reinsurance agreements to determine the proper accounting.

Reinsurance Auditing Considerations

.85 Auditors of companies with significant reinsurance contracts may want to request that management state in its representation letter to the auditor that there are no side agreements to reinsurance contracts, or, alternatively, that the auditor has been informed of any such agreements to enable a determination as to whether the company has properly considered these in the accounting analysis for the contract. Auditors of companies with significant reinsurance contracts also may consider directing procedures under AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1) toward these arrangements to identify any of the following:

- Contracts backdated to avoid retroactive reinsurance accounting on coverage of losses that had already been incurred
- Side agreements to reimburse the reinsurer for covered losses or to return profits under a contract in a different accounting period, which may compel accounting accruals
- Linked contracts where losses experienced under one will be reimbursed under another in the future and which should be considered together in the risk transfer analysis
- Contracts whose terms do not make economic sense and indicate a side agreement, or linkage, with another contract that should be considered in the accounting evaluation
- Exclusive reinsurance arrangements with offshore assuming companies that raise consolidation questions
- Commutations where the settlements are not in accordance with contract terms and suggest a noncontractual agreement on the allocation of profits and losses
- Contracts where the risk transfer analysis supporting the accounting evaluation differs materially from and cannot be reconciled to cash flow analyses included in the underwriting file

.86 Paragraph .02 of AU section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *Professional Standards*, vol. 1), states that an independent auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he is aware at the time. Are company disclosures with respect to significant reinsurance agreements in accordance with FASB Statement No. 113, and are disclosures with respect to ongoing regulatory investigations, if any, adequate?

.87 Finite reinsurance investigations may reveal errors in financial statements on which the auditor has previously reported. AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1), provides guidance when the auditor becomes aware of facts that may have existed at the date of the auditor's report that may have affected the report had he or she been aware of such facts. In addition, Practice Alert 94-1, *Dealing with Audit Differences* (AICPA, *Technical Practice Aids*, PA sec. 16,010), provides guidance to auditors assessing the materiality of financial statement errors.

Fair Value Measurements

FASB Statement No. 157

.88 In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

.89 Prior to this statement, there were different definitions of fair value and guidance for applying those definitions was dispersed among many accounting pronouncements. Difference in the existing guidance created inconsistencies that added to the complexity in applying GAAP. FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. Readers can access the full text of FASB Statement No. 157 on the FASB Web site at www.fasb.org.

.90 Auditors would be advised to pay special attention to the Fair Value Hierarchy discussed in paragraphs 22–30 of FASB Statement No. 157 as companies' determination of the hierarchical level of the fair value input could have significant impact on the valuation calculation.

.91 At its October 17, 2007 meeting, the FASB decided not to add a project to its agenda to defer the effective date of FASB Statement No. 157 in its entirety. However, the FASB directed the staff to evaluate other potential deferral alternatives, including a deferral for all assets and liabilities except financial assets and liabilities and derivatives subject to the scope of FASB Statement No. 133, private entities, or "small" entities. The FASB will discuss those alternative deferral options at a future board meeting. Readers should be alert to any further developments.

FASB Statement No. 159

.92 Subsequent to the issuance of FASB Statement No. 157, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.93 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157. The choice to adopt early should be made within 120 days of the beginning of the fiscal year of adoption (for calendar year-end entities, by April 2007), provided the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year of adoption. The FASB and SEC have expressed concern in the way some early adopters have applied the transition provisions of the standard. The AICPA Center for Audit Quality (CAQ) issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard such as this is applied in a good faith manner consistent with those objectives and principles. Specifically, the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FASB Statement No. 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

The NAIC's Sarbanes-Oxley Initiative Update

.94 The NAIC adopted changes to the Model Audit Rule related to Sarbanes-Oxley during its fall 2006 meeting, with the majority of the changes effective for 2010. The key areas of focus for the NAIC were auditor independence, corporate responsibility, and enhanced financial disclosures.

Significant Changes in Model Audit Rule

.95 Highlights of the significant changes made to the Model Audit Rule related to Sarbanes-Oxley include:

- Section 7: The time allowed to serve in the capacity as the lead or coordinating audit partner was decreased from seven to five consecutive years with a new five year break in service (previously two years), effective beginning with year 2010 statutory audits.
- Section 7: There is a list of nonaudit services that cannot be performed by the auditor in conjunction with the audit (the prohibitions generally agree with those designated by the SEC), effective for the year 2010 statutory audits.
- Section 9: To the extent required by AU section 319 for those insurers required to file a Management's Report of Internal Control Over Financial Reporting pursuant to Section 16 (see the "Section 16" bullet point that follows in this alert), the independent accountant should consider the most recently available report in planning and performing the audit of statutory financial statements.
- Section 11: Auditors should prepare a written communication of any unremediated material weaknesses that the insurer will furnish the domiciliary commissioner, effective beginning with year 2010 statutory audits. The current Model Audit Rule requires the auditor to prepare a report of significant deficiencies and material weaknesses in the insurer's internal control structure noted by the auditor during the audit. The AICPA NAIC Task Force has, for several years, undertaken efforts to confirm that states will accept the reporting of only those significant deficiencies and material weaknesses that are unremediated as of the balance sheet date, and it will continue to do so until the year 2010 effective date of the revised Model Audit Rule.

Until the revisions of this section become effective in 2010, representatives of the AICPA plan on obtaining negative clearance from regulators that they will continue to follow guidance contained in a March 9, 2005 letter sent to regulators. This letter contained suggested guidance for complying with Section 11 of the Model Audit Rule since the term *significant deficiencies* had a different definition under Sarbanes-Oxley than it had under Section 11 of the Model Audit Rule.

- Section 14: There are new specifications for the responsibilities of audit committees and the required qualifications of audit committee members, effective January 1, 2010. The premium threshold that triggers the requirement for independent audit committee members is $300 million assumed and direct premiums. The premium range for a majority of independent audit committee members is $300 to $500 million. The requirement for a supermajority of independent audit committee members is $500 million in premiums. Notwithstanding premium volume, all insurers are encouraged to structure their audit committees with at least a supermajority of independent audit committee members.

- Section 16: Every insurer required to file an audited financial report that has annual direct written and assumed premium of $500 million or more shall prepare a report of the insurers' or group of insurers' *Internal Control Over Financial Reporting* and file it with their insurance commissioner, effective December 31, 2010. The Model Audit Rule also includes a list of what should be included in *Management's Report of Internal Control Over Financial Reporting*. This report is prepared by management and is not audited. Section 9 (highlighted above) specifies the independent accountant's responsibilities as they pertain to this report.

Implementation Guide for Changes in Model Audit Rule:

.96 In September 2006, the NAIC adopted an implementation guide that was developed to assist insurers, auditors, and regulators in implementing the changes to the Model Audit Rule related to Sarbanes-Oxley. The new requirements within the Model Audit Rule related to auditor independence, corporate governance and internal control over financial reporting are proposed to become effective in 2010. As such, the implementation guide was published to assist companies in planning and preparing for compliance with the new requirements when they become effective. The implementation guide is included as Appendix G of the *Accounting Practices and Procedures Manual*, and is also included on the NAIC Web site at: www.naic.org/documents/committees_e_naic_aicpa_implementation_guide_exposed-Final_0314.pdf.

Recent Auditing and Attestation Pronouncements and Related Guidance

.97 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.98 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A), to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120) • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	See the "AICPA Risk Assessment Standards" section in this alert.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325.01–.04), which interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.
Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330.01–.06), which interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This PA responds to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.
AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This PA provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditor's report.
PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This standard replaces the PCAOB's previous internal control standard, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.
PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting* Issue Date: July 2007	This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client's audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the SEC or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed

Recent Auditing and Attestation Pronouncements and Related Guidance	
(Applicable to audits conducted in accordance with PCAOB standards)	service, discuss with the audit committee the potential effects of the proposed service on the firm's independence, and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524. This rule is effective for audits of fiscal years ending on or after November 15, 2007.
PCAOB Conforming Amendments to the Interim Auditing Standards Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in Appendix 3 of PCAOB Release No. 2007-005A at www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.
PCAOB Report, *Report on the Second-Year Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report is based on PCAOB inspections that looked at parts of approximately 275 audits of internal control over financial reporting by registered public accounting firms. Inspections focused on four areas: integrating the audits of financial statements and internal control, using a top-down approach, using the work of others, and assessing risk.
PCAOB Report, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (AICPA, *PCAOB Standards and Related Rules*, Select SEC-Approved PCAOB Releases) Issue Date: January 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report focuses on aspects of the PCAOB's interim auditing standards that address the auditor's responsibility with respect to fraud, specifically AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Staff Questions and Answers, *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	Topics covered include the following: • The application of Rule 3522 (a) when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm • Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction • Whether a registered public accounting firm's independence is affected by the IRS's subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b) • Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself • Clarification of the term *other change in employment event* as it relates to Rule 3522(c)
PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 100—PCAOB Staff Questions and Answers") Issue Date: October 2006 (Applicable to audits conducted in accordance with PCAOB standards)	The guidance provides direction for auditing a company's estimation of the fair value of stock options granted to employees pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment*, which became applicable for financial statements of companies with fiscal years ending on or after June 15, 2006.

The Auditor's Communication With Those Charged With Governance

.99 In December 2006, the ASB issued SAS No. 114, which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and is effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to 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. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.100 SAS No. 114 recognizes the importance of effective two-way communication to the audit. It provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61.

However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires significant matters communicated with those charged with governance to be documented.

Identifying Those Charged With Governance

.101 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those 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.

.102 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.103 Because there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.104 In May 2006, the AICPA ASB issued SAS No. 112, which establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, as amended. The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued, the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2. However, with the adoption of PCAOB Auditing Standard No. 5, the PCAOB redefined these terms, which now differ from SAS No. 112.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.
- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, and identifies indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.
- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.

- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.
- Contains illustrative written communications to management and those charged with governance.

How Revisions of SAS No. 112 Affect Practice

.105 As auditors gain a better understanding of what needs to be communicated to management and those charged with governance, there may be more control deficiencies that are identified as significant deficiencies and material weaknesses and that are then communicated to management and those charged with governance. Auditors may emphasize and therefore spend more time evaluating identified control deficiencies than in the past.

Discussions With Management and Others

.106 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. Auditors may have to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor who does not provide attest services for the client can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.107 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of material weaknesses. Another reason is that auditors have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in written communication as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.108 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct* or *remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented, detected, and corrected by the client.

Issues for Audits of Smaller Entities

.109 One issue that has arisen in audits of smaller entities is the increase in costs as a result of the time the auditor spends documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.110 Another issue that has caused concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, detecting, or correcting material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, because doing so would impair independence.[6] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.111 The requirements of SAS No. 112 introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and ISAs.

.112 The AICPA has published the AICPA Audit Risk Alert titled *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in implementation of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

AICPA Risk Assessment Standards

.113 In March 2006, the AICPA ASB issued eight SASs referred to as the risk assessment standards (SAS Nos. 104–111). Although the SASs include many of the underlying concepts and detailed performance requirements contained in existing standards, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risks of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between the risks, controls, audit procedures, and conclusions. The risk assessment standards are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier applications permitted. The following table lists the eight SASs and their effects on existing standards.

Statement on Auditing Standards	***Effect on Existing Standards***
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")* (AICPA, *Professional Standards*, vol. 1, AU sec. 230)	This statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230A).
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	This statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A).

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[6] See Ethics Ruling 101-3, "Performance of nonattest services," of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

Statement on Auditing Standards	*Effect on Existing Standards*
SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)	This statement supersedes SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326A).
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)	This statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312A).
SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)	This statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 310), and supersedes SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A).
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314)	This statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1, AU sec. 318)	This statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)	This statement amends SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350A).

Key Provisions of the Risk Assessment Standards

.114 Whether due to error or fraud, the new risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks that may lead to a material misstatement in the client's financial statements and any mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations of the Treadway Commission's framework, www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs will most likely result in significant changes to firm audit methodologies and the training of personnel. Therefore, it is recommended that auditors allow ample time in advance of the required implementation date. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Companion Audit Guide

.115 In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Audit Documentation Technical Practice Aids

.116 In May 2007, the ASB issued two TIS related to SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which was issued in December 2005.

.117 TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.118 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*), discusses whether the provisions of SAS No. 103 related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance*

.119 A key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.120 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date
- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.121 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf. Readers should also note the PITF is currently working on a practice alert that addresses auditing and other considerations related to electronic information that it plans to issue during the third quarter of 2007.

PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*

.122 In May 2007, the PCAOB adopted Auditing Standard No. 5, which was later approved by the SEC on July 25, 2007. This standard replaces Auditing Standard No. 2. Auditing Standard No. 5 is principles-based and presents a risk-based, top-down approach designed to increase the likelihood that material weaknesses will be found before resulting in a material misstatement of a company's financial statements, while eliminating unnecessary procedures. The standard was also designed to make audits more scaleable for smaller or less complex companies. The PCAOB worked closely with the SEC to coordinate Auditing Standard No. 5 with the guidance to public company management that was approved by the SEC in May 2007. Mark Olson, PCAOB Chairman, stated "The new standard is more risk-based and scalable, which will better meet the needs of investors, public companies, and auditors alike."

.123 This new standard is required for all audits of internal control for fiscal years ending on or after November 15, 2007. However, early adoption is permitted and encouraged. For more information, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk).

.124 Readers should also be aware that the ASB has a project underway to revise AU Section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards* vol. 1), as well as AT Section 501 in response to the issuance of Auditing Standard No. 5 and the IAASB project related to this topic. However, the ASB revision of the standard is not expected until 2008, when the IAASB will have made further progress on its proposed ISA.

Recent AICPA Independence and Ethics Pronouncements

.125 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.126 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions (FSPs) (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA Statement of Position (SOP) 07-1 (AICPA, *Technical Practice Aids*, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*
TIS section 6140.20–.22 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss not-for-profit organizations fund-raising expenses.
TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various employee benefit plan topics.
TIS section 6300.25–.35 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various issues related to SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.127 Of the accounting pronouncements and related 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. The AICPA general *Audit Risk Alert—2007/08* and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077, or go online at www.cpa2biz.com.

SOP 07-1

.128 In June 2007, Accounting Standards Executive Committee (AcSEC) issued SOP 07-1, *Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*. At its October 17, 2007 meeting, the FASB added a project to its agenda to indefinitely defer the effective date of SOP 07-1. For entities that have not yet adopted the provisions of SOP 07-1, early adoption would not be permitted. The FASB directed the staff to prepare a draft of a proposed FSP for vote by written ballot. The FASB decided that the proposed FSP should have a 30-day comment period. Readers should be alert to any further developments.

.129 SOP 07-1 provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies* (guide). For those entities that are investment companies under this SOP, the SOP also addresses whether the specialized industry accounting principles of the guide (referred to as investment company accounting) should be retained by a parent company in consolidation or by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity (referred to as an equity method investor).

.130 SOP 07-1 also provides guidance for determining whether investment company accounting applied by a subsidiary or equity method investee should be retained in the financial statements of the parent company or an equity method investor. That guidance should be used to evaluate relationships between (1) the parent company or equity method investor and (2) investees to determine, among other matters, whether the parent company or equity method investor (through the investment company) is investing for current income, capital appreciation, or both, rather than for strategic purposes. If the application of that guidance leads to the conclusion that investment company accounting should not be retained in the financial statements of the parent company or equity method investor, the financial information of the investment company should be adjusted as if investment company accounting had not been applied by the subsidiary or equity method investee for purposes of the consolidated financial statements of the parent company or the application of the equity method of accounting by an equity method investor.

FIN 48

.131 FIN 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, was issued in June 2006 and is effective for fiscal years beginning after Dec. 15, 2006. On November 7, 2007, FASB voted to defer the effective date of FIN 48 for nonpublic entities for financial statements for fiscal years beginning after December 15, 2007. This represents a one-year delay. FIN 48 states that the financial statement tax accrual may only contain positions that meet the "more-likely-than-not" standard, and any variances must be disclosed in the financial statements. This translates to more work for accountants and auditors on the tax accrual, as you evaluate even garden-variety issues, such as unreasonable compensation or expensing versus capitalization. It also means that positions taken on the return (or that were taken in any open year) that do not meet the "more-likely-than-not" standard will be disclosed and will likely be subject to increased IRS scrutiny.

.132 The evaluation of a tax position in accordance with this interpretation is a two-step process. The first step is recognition: The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement: A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

.133 Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in FASB Statement No. 109, *Accounting for Income Taxes*, is not an appropriate substitute for the derecognition of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on the sufficiency of future taxable income is unchanged by this interpretation.

.134 For calendar-year corporations, the new rules would seem to initially take effect with first quarter 2007 results. However, the new rules require calendar-year corporations to have a "clean" starting point for their tax accounts at Jan. 1, 2007. In other words, the deferred tax asset and deferred tax liability accounts on that date must be determined in accordance with the standards of FIN 48.

.135 A practice guide for accountants, auditors, and tax advisers has been posted to the AICPA's Tax Center at www.aicpa.org/tax under the Resources tab. An AICPA CPE course on accounting for income taxes that has been updated for FIN 48 is now available and an AICPA webcast also is being presented. Go to www.cpa2biz.com for more information on these products.

Additional Implementation Guidance for FIN 48

FASB Staff Position FIN 48-1

.136 In May 2007, FASB issued FSP FIN 48-1, *Definition of Settlement in FASB Interpretation No. 48*. The purpose of this FSP is to amend FIN 48 to clarify that a tax position could be effectively settled upon examination by a taxing authority. Assessing whether a tax position is effectively settled is a matter of judgment because examinations occur in a variety of ways. In determining whether a tax position is effectively settled, an enterprise should make the assessment on a position-by-position basis, but an enterprise could conclude that all positions in a particular tax year are effectively settled. The FSP describes conditions for evaluating effective settlement of tax positions, provides guidance for determining effective settlement with respect to examination of tax positions by taxing authorities, and provides a number of conforming changes to FIN 48 with respect to the new settlement terminology discussed in the FSP. The full text of the FSP can be found at www.fasb.org/fasb_staff_positions/fsp_fin48-1.pdf.

FIN 48 and Independence

.137 In some instances, making such determinations under FIN 48 can involve relatively complex judgments, and practitioners have asked whether they may assist clients in applying FIN 48 without impairing their independence. At its July 19–20, 2007 meeting, the Professional Ethics Executive Committee (PEEC) considered this question and concluded that a member may assist an attest client in applying FIN 48 provided that the member is satisfied that the client understands the reasons why a specific tax position does or does not meet the more-likely-than-not threshold and the basis for the determination of the amount of related unrecognized tax benefits. In making this determination the PEEC referred to its longstanding position, in Interpretation 101-3, "Performance of nonattest services" under Rule 101, *Independence* (AICPA, *Professional Standards,* vol. 2, ET sec. 101.05), General Requirement No. 2, that the requirement that the client's "designated individual" possess suitable skill, knowledge, or experience to oversee the services does not mean that the individual must possess the technical expertise that the member possesses or the ability to perform or reperform the services.

.138 The PEEC believes that in most cases a member should be able to advise the client about whether a tax position meets the more-likely-than-not threshold and the likelihood that portions of the related tax benefit will not be realized, and adequately inform them of the factors upon which the member's advice was based and thereby enable the client to make an informed judgment on the results of the member's services and take responsibility for the work. In those instances, the PEEC believes that assisting the client in applying FIN 48 would not impair the member's independence. The staff of the AICPA Professional Ethics Division has issued nonauthoritative guidance on this matter by adding question 23 to the Q&As that appear on the division's Web site at www.aicpa.org/download/ethics/nonattest_q_a.pdf.

On the Horizon

.139 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to the insurance industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.140 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. 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 in addition to those discussed here. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov
National Association of Insurance Commissioners (NAIC)	www.naic.org
International Accounting Standards Board (IASB)	www.iasb.co.uk/

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Overhaul Project—AICPA Audit and Accounting Guide *Property and Liability Insurance Companies*

.141 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Property and Liability Insurance Companies*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1990. During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.

Auditing Pipeline—Nonissuers

ASB Clarity Project

.142 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB approved for exposure a discussion paper titled *Improving the Clarity of ASB Standards*. This discussion paper seeks feedback on proposed changes to the standards, including:

- Establishing objectives for each of the standards, and the auditor's obligations related to the objectives
- Structural and drafting improvements to make the standards easier to read and understand
- Inclusion, in the explanatory material of the standards, of special considerations related to audits of public entities and small entities
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards

.143 The period to comment ended June 15, 2007. The discussion paper can be accessed at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

Convergence With International Standards

.144 The ASB has created a number of task forces charged with monitoring specific activities of the IAASB and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of ISA. The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.145 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, the ASB previously decided to defer to issuance of a final revised AT section 501 until the PCAOB issued its amendments and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www.aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of **Present Fairly in Conformity With Generally Accepted Accounting Principles**

.146 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards titled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA, *Professional Standards*, vol. 1, AU sec. 411]) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www.fasb.org. The ASB will issue its final SAS coincidentally with the FASB's and PCAOB's issuance of their final standards.

Auditing Pipeline—Issuers

.147 Guidance issued by the PCAOB is included in the section of this alert titled "Recent Auditing and Attestation Pronouncements and Related Guidance." For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), mentioned previously.

Accounting Pipeline

.148 Presented below are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year alert have not been finalized as of the date of this writing, and thus are included again.

International Accounting Standards Board Insurance Contracts Project

.149 The International Accounting Standards Board (IASB) has untaken a project to develop an International Financial Reporting Standard (IFRS) on accounting for insurance contracts. The project will address accounting by both insurers and policyholders. The IASB is currently receiving comments on the discussion paper *Preliminary Views on Insurance Contracts* and currently expects an exposure draft to be published in 2009. The final IFRS standard is not expected to be completed until 2010. Additional information can be obtained from the IASB's Web site at: www.iasb.co.uk/.

.150 In response, the FASB has issued an invitation to comment on *An FASB Agenda Proposal: Accounting for Insurance Contracts by Insurers and Policyholders, Including the IASB Discussion Paper,* Preliminary Views on Insurance Contracts. The full invitation can be obtained from the FASB's Web site at: http://72.3.243.42/draft/ITC_Insurance_Contracts.pdf.

Business Combinations

.151 Phase one of the business combination project resulted in the issuance of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*. In those statements, the FASB eliminated the use of the pooling of interests method of accounting for business combinations and addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. The objective of phase two of this project is to standardize business combination accounting through the convergence of the FASB and IASB accounting standards and by reconsidering the existing guidance for the purchase method of accounting for business combinations. Among the main proposals are the following:

- All acquisitions of businesses be measured at the fair value of the business acquired.
- Substantially all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.
- Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.152 In June 2005, the FASB and IASB issued a number of exposure drafts, for which comment periods ended in October 2005. Redeliberations began in January 2006 and were completed in June 2007. The FASB and IASB expect to issue final statements during the fourth quarter of 2007. Four standards are expected to be issued:

- Proposed FASB Statement No. 141(R) and IFRS No. 3(R), *Business Combinations*
- Proposed FASB Statement No. 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*
- Proposed International Accounting Standard (IAS) Statement No. 27(R)

.153 Readers should remain alert to the final issuances and visit the FASB Web site for further information.

Financial Guarantee

.154 On April 18, 2007, the FASB issued an exposure draft of a proposed statement, *Accounting for Financial Guarantee Insurance Contracts*, with a 60-day comment period. The comment period ended on June 18, 2007. On September 4, 2007, the FASB held a public roundtable meeting with respondents to the exposure draft to discuss significant issues raised in comment letters.

.155 The objective of this project is to improve the comparability of financial reporting by insurance enterprises by establishing a single approach for recognition and measurement of financial guarantee insurance contracts under FASB Statement No. 60. The focus of that reporting is on premium revenue and claim liabilities. A related objective is to improve the usefulness of information provided to users of financial statements by expanding disclosures about financial guarantee insurance contracts.

.156 The FASB plans to begin redeliberations of the exposure draft in the fourth quarter 2007. Readers should remain alert to any final issuances and visit the FASB Web site for further information.

Fair Value Option

.157 During phase one of the FASB's fair value option project, the FASB issued FASB Statement No. 159, which was previously discussed. In phase two of the project, the FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase two are expected to begin in the third quarter of 2007. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.158 In December 2006, the FASB issued an exposure draft titled *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure draft ended in March 2007, and the FASB has begun redeliberations to consider significant issues raised by respondents. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133 including how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entity's financial position, results of operations, and cash flows. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.159 The FASB is working on a project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, to address issues related to the permitted activities of a qualifying special-purpose entity (QSPE), isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, the FASB issued the exposure draft, *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During 2007, the FASB expects to address issues related to the permitted activities of a QSPE and then issue another exposure draft during the fourth quarter of 2007 containing potential amendments to FASB Statement No. 140. See the FASB Web site for complete information.

Earnings Per Share

.160 The FASB and IASB have been working together to resolve differences between FASB Statement No. 128, *Earnings per Share*, and IAS Statement No. 33, *Earnings per Share*. This project is part of the larger FASB project, Short-term International Convergence, which has resulted in the issuance of a number of FASB

Statements. Currently the FASB and IASB are addressing significant differences that remain relating to instruments that can be settled in cash or shares and are classified as a liability on an entity's balance sheet. The FASB and IASB are considering modifications to the treasury stock method and several scoping issues in which either the FASB or IASB has issued or may issue more detailed implementation guidance on earnings per share that may create a convergence difference. The FASB and IASB are expected to issue an exposure draft for public comment during the third quarter of 2007. This exposure draft will be the third exposure draft the FASB has issued on the earnings per share project. The project and current exposure draft can be reviewed on the FASB Web site.

FASB Codification and Retrieval Project

.161 The goal of this FASB project is to create a single, authoritative codification of U.S. GAAP. The codification will integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, EITF, and the SEC). The codification will have a three layered structure: topic, subtopic, and section. The FASB has structured the topics into three primary areas: overall presentation, transactional (or financial statement account), and industry. The overall presentation area addresses presentation of financial information but does not address items such as recognition, measurement, or derecognition. The transactional or financial statement account area addresses accounting recognition, measurement, or derecognition. The industry area includes guidance unique to the industry. A codification draft is expected in 2007 and will have an extended verification period to ensure that it accurately reflects U.S. GAAP. Once the FASB addresses respondent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards. Readers can track progress of the Codification and Retrieval Project on the FASB Web site at www.fasb.org/project/codification&retrieval_project.shtml.

GAAP Hierarchy

.162 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor that is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonissuers" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.163 ***Proposed FASB EITF Issues.*** Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.164 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

.165 The following are various resources that practitioners engaged in the insurance industry may find beneficial.

Publications

.166 Practitioners may find the following publications useful with respect to the insurance industry:

- Audit and Accounting Guide *Life and Health Insurance Entities* (2006) (product no. 012636kk)
- Audit and Accounting Guide *Property and Liability Insurance Companies* (2006) (product no. 012676kk)
- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2007) (product no. 012517kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2007) (product no. 012777kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- AICPA *Compilation and Review Alert—2007/08* (product no. 022308kk)
- AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk)
- AICPA Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Life & Health Insurance Companies—Checklists and Illustrative Financial Statements* (product no. 008957kk)
- *Property & Liability Insurance Companies—Checklists and Illustrative Financial Statements* (product no. 008967kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.167 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, TPAs, 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.

Continuing Professional Education

.168 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191 [DVD]). 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.
- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

.169 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.170 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics.

.171 To register or learn more, visit www.cpa2biz.com.

Webcasts

.172 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.173 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.174 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.175 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.176 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. You can reach the Technical Hotline at (877) 242-7212.

Ethics Hotline

.177 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.

AICPA CAQ

.178 The CAQ (formerly the Center for Public Company Audit Firms) was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.179 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ visit http://thecaq.aicpa.org.

AICPA Industry Expert Panel—Insurance

.180 For information about the activities of the Insurance Industry Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel _insurance.htm.

Insurance Industry Web Sites

.181 The Internet covers a vast amount of information that may be valuable to auditors of insurance entities, including current industry trends and developments. Some of the more relevant sites for auditors with insurance clients include those shown in the following table:

Organization	*Web Site*
National Association of Insurance Commissioners (NAIC)	www.naic.org/
Insurance Information Institute (III)	www.iii.org
Citizens Property Insurance Corporation of Florida (Florida Citizens)	www.citizensfla.com
Florida Hurricane Catastrophe Fund (FHCF)	www.sbafla.com/fhcf
Texas Windstorm Insurance Association (TWIA)	www.twia.org
Louisiana Citizens Property Insurance Corporation	www.lacitizens.com
The Mississippi Windstorm Underwriting Association (MWUA)	www.msplans.com/mwua
The Mississippi Residential Property Insurance Underwriting Association (MRPIUA)	www.msplans.com/MRPIUA
Alabama Insurance Underwriting Association (AIUA)	www.alabamabeachpool.org

.182 The insurance practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

* * * *

.183 This Audit Risk Alert replaces *Insurance Industry Developments—2006/07*.

.184 The Audit Risk Alert *Insurance Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to wboyd@aicpa.org or write to:

William Boyd, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

.185

Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov

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AAM Section 8050

Bank, Credit Union, and Other Depository and Lending Institution Industry Developments—2007/08

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS

BANK, CREDIT UNION, AND OTHER DEPOSITORY AND LENDING INSTITUTION INDUSTRY DEVELOPMENTS—2007/08

This Audit Risk Alert is intended to provide auditors of financial statements of banks, credit unions, and other depository and lending institutions with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

Kenneth R. Biser, CPA
Technical Manager
Accounting and Auditing Publications

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits of financial institutions and other lenders. This alert can also be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory 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 financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards***. When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The financial institutions industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic, and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on the entity's financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, GDP increased at an annual rate of 2.9 percent in 2006, consistent with the pace of growth experienced in 2005 when GDP increased by 3.1 percent. During the first quarter of 2007, GDP increased by an annual rate of only 0.6 percent. However, according to second quarter preliminary estimates, GDP increased at an annual rate of 4.0 percent.

.11 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, with an annual average rate of 4.6 percent representing approximately 7 million people. The 2006 rates represent the lowest annual rate and total number of jobless since 2000, according to the U.S. Department of Labor, Bureau of Labor Statistics. During the first half of 2007, the unemployment rate averaged 4.5 percent. These data further demonstrate the economic growth the United States has experienced since the beginning of 2006.

.12 After a period of rising rates during the first half of 2006, the Federal Reserve kept its target for the federal funds rate at 5.25 percent for 10 consecutive meetings (June 2006–August 2007). At that time, the Federal Reserve indicated future federal fund rate adjustments would likely depend upon the outlook for economic growth and inflation. Since its August 2007 meeting and in response to shaky financial market conditions, the Federal Reserve has taken several action steps. It announced that it would provide reserves as necessary through the open market to facilitate the orderly functioning of financial markets by promoting trading in the federal funds market at rates close to the 5.25 percent target rate. On August 17, 2007, it announced that financial market conditions had deteriorated and tighter credit conditions and increased uncertainty has the potential to restrain economic growth. Then at its September meeting, the Federal Reserve decided to lower its target for the federal funds rate 50 basis points to 4.75 percent citing increased uncertainty surrounding the economic outlook. The Federal Reserve also decided to decrease the discount rate 50 basis points to 5.25 percent to consistently keep the spread between the primary credit rate and the target federal funds rate at 50 basis points. Auditors should remain alert to developments in the financial markets and how they may affect your audit engagements.

Industry Trends and Conditions

The State of the Financial Institution Industry

.13 According to the Federal Deposit Insurance Corporation (FDIC) Quarterly Banking Profile issued for the first quarter of 2007, higher credit expense at large institutions and narrower net interest margins at smaller institutions caused a decrease in earnings of FDIC-insured institutions during the quarter. Industry net income was $36 billion for the first quarter of 2007, which is 2.5 percent less than the earnings posted in the first quarter of 2006. This is the largest year-over-year decline in quarterly earnings since 2001. Much of the decrease in income was attributable to a change in the way earnings were reported in the aftermath of large corporate restructurings. Lower operating results at a number of institutions also contributed to the earnings drop. Evidence of pressure on earnings was widespread as a majority of institutions reported lower quarterly net income.

.14 Average return on assets (ROA) for institutions for the first quarter of 2007 was 1.21 percent, compared to 1.34 percent in the first quarter of 2006. Fifty-nine percent of all institutions experienced a decline in quarterly ROA. This is the lowest first quarter ROA for the industry since 2001.

.15 Provisions for loan losses totaled $9.2 billion in the first quarter of 2007. This reflects a 54.6 percent increase compared to the first quarter of 2006. Noninterest expense also increased $3 billion during 2007 as several large banks reported higher payroll expenses. Increased interest income helped to offset these higher costs.

.16 Auditors should consider the pressures financial institutions are facing when planning and performing the audit engagement. Auditors have 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. Paragraph .32 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), explains that when obtaining information about the entity and its environment, an auditor should consider whether the information indicates that one or more fraud risk factors are present. The auditor should use professional judgment in determining whether a risk factor is present and should be considered in identifying and assessing the risks of material misstatement due to fraud. Paragraph .33 of AU section 316 lists three conditions generally present when fraud exists: incentive or pressure to perpetrate fraud, an opportunity to carry out the fraud, and attitude or rationalization to justify the fraudulent action.

The State of the Banking Industry

.17 According to the FDIC's Quarterly Banking Profile, at the end of March 2007 there were 8,650 FDIC-insured commercial banks and savings institutions reporting financial results, which represented a net decline of 31 institutions compared to reporting institutions at the end of 2006. There were 41 new banks reporting during the first quarter while 72 institutions were absorbed by mergers. One FDIC-insured bank, with $15.3 million in assets, failed during the quarter. The FDIC's "problem list" increased during the quarter from 50 to 53 institutions.

.18 Total deposits grew by $70 billion, which was the smallest quarterly increase since the third quarter of 2003. Domestic deposits increased by $63.3 billion during the quarter. Interest bearing account deposits grew by $43.8 billion, which outweighed a decline in noninterest bearing deposits.

.19 As lending markets continue to show weak results, banking executives are searching for alternative uses for excess capital. Since the beginning of 2007, the challenge has been to find appropriate assets to maximize excess capital. The trend, thus far, is to utilize assets outside of the usual industry capital allocations. Banks are beginning to invest in investments like embedded derivates, which are riskier than loans. This is being done in an attempt to deploy excess capital. Another result of increased capital is the issuance of larger dividends to shareholders. The impact of increased dividends to shareholders is a decrease in each respective institution's retained earnings.

The State of Credit Unions

.20 In a June 21, 2007, letter to members, the Chairman of the National Credit Union Administration (NCUA) reported that the condition of the credit union industry remains sound. This statement is based on data from call reports submitted to the association by all federally insured credit unions. The letter points out that very strong share growth, increasing net worth dollar levels, and lower delinquency and charge-off loan ratios have all contributed to the sound state of the credit union industry. The letter explained that loan growth this quarter continued to come from the real estate portfolio. Credit unions that hold real estate portfolios are urged to continue to offer members sound products.

.21 Credit unions are encouraged to continue to assess their asset-liability management and liquidity management planning processes. Auditors should be aware of management's asset-liability and liquidity management processes when performing the audit. Understanding such processes will assist the auditor in the risk assessment. AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors on analytical procedures used during the planning phase of the audit and those used as substantive tests.

NCUA and Financial Crimes Enforcement Network Host First Ever Joint Seminar on Bank Secrecy Act Compliance Programs

.22 The NCUA and Financial Crimes Enforcement Network (FinCEN) recently held a joint Web-based seminar titled "BSA: A Year in Review and Setting the Table for 2007." The goal of the seminar was to educate credit unions about their Bank Secrecy Act (BSA) obligations. More than 2,000 members of the credit union industry participated in the seminar.

The State of Financial Service Companies[1]

.23 Finance companies provide lending and financing services to consumers (consumer financing) and to business enterprises (commercial financing). A number of finance companies engage solely in consumer or commercial financing activities; others provide both types. Examples of financial service companies include insurance companies, businesses that provide financing to entice the purchase of goods, and consumer finance companies.

.24 Numerous state and federal statutes affect finance companies' operations. Some statutes apply only to specific types of activities. Regulations affecting finance companies generally are limited to matters such as loan amounts, repayment terms, interest rates, and collateral; they generally do not address financial accounting and reporting.

Delinquencies Increase in Latest Mortgage Bankers Association National Delinquency Survey

.25 The delinquency rate for mortgage loans on 1-to-4-unit residential properties stood at 5.12 percent of all loans outstanding in the second quarter of 2007 on a seasonally adjusted basis, up 28 basis points from the first quarter of 2007 and up 73 basis points from 1 year ago, according to the Mortgage Bankers Association (MBA) National Delinquency Survey.

.26 The delinquency rate does not include loans in the process of foreclosure. The percentage of loans in the foreclosure process was 1.40 percent of all loans outstanding at the end of the second quarter, which is an increase of 12 basis points from the first quarter of 2007 and 41 basis points from 1 year ago.

.27 The rate of loans entering the foreclosure process was 0.65 percent on a seasonally adjusted basis, 7 basis points higher than the previous quarter and up 22 basis points from 1 year ago. This quarter's foreclosure starts rate is the highest in the history of the survey, with the previous high being last quarter's rate.

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[1] Practitioners may also find the AICPA's Audit Risk Alert *Insurance Industry Developments—2006/2007* helpful when auditing financial service companies. This alert will help you plan and perform your audits by identifying the significant business risks that may result in the material misstatement of your client's financial statements.

.28 Similar to last quarter, the national delinquency and foreclosure rates are being driven by what is taking place in a few large states. Additionally, the performance of prime and subprime adjustable rate mortgages (ARMs) is contributing significantly to the overall results.

.29 As reported in the June 13, 2007, issue of *American Banker*, financial service companies will continue to reach out to the nation's rapidly growing minority community. Financial service companies are focusing on smaller cities such as Albany, New York, and Toledo, Pennsylvania, as alternatives to competing for immigrant deposits in metropolitan cities like New York City or Los Angeles.

The State of Mortgage Banking

.30 *American Banker* recently reported that home resales hit a 4-year low due to continued price decline. Many in the housing industry believe the decline in resales signifies a protracted housing slump. Another issue contributing to sluggish home sales is the rising number of foreclosures of properties financed with subprime debt. Auditors should consider the current real estate climate when conducting an audit of a mortgage company. Awareness of the business environment in which the institution operates could provide valuable insight on loan policies and the organization's internal controls. For example, mortgage companies that are subsidies of insured depository institutions are subject to increased scrutiny from underwriters. Pressure from reduced home sales could entice management to override internal controls. For example, a mortgage banking manager may be enticed to circumvent the company's loan application review policies to make a loan to a high risk borrower. AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1), provide guidance for the auditor's consideration of an entity's internal control in an audit of financial statements. As home sales decline, many financial institutions may begin to aggressively cut expenses. Per AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), auditors have a responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time not to exceed one year from the date of the financial statements being audited.

.31 Auditors should also consider whether the institution is considering or in the process of restructuring its loan origination or securitization departments. The auditor may refer to Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards Nos. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, and 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, for guidance. Additional guidance for public companies is included in Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 100, *Restructuring and Impairment Charges*, which provides guidance on the accounting for and disclosure of certain expenses and liabilities commonly reported in connection with restructuring activities and business combinations and the recognition and disclosure of asset impairment charges.

.32 On June 8, 2007, the Federal Financial Institutions Examination Council (FFIEC), which consists of the Board of Governors of the Federal Reserve System, FDIC, NCUA, Office of the Comptroller of the Currency (OCC), and Office of Thrift Supervision (OTS), published final illustrations of consumer information intended to assist institutions as they implement the consumer protection portion of the interagency guidance on nontraditional mortgage product risks. The three illustrations present examples of the types of information contemplated in the guidance. Institutions have discretion in determining whether to tailor and use the illustrations provided.

Federal Reserve Panel Announcement

.33 In June 2007, the Federal Reserve Board announced the panelists for its public hearing under the Home Ownership and Equity Protection Act. They include key players in the home mortgage market, including the subprime sector lenders, brokers, secondary market participants, consumer advocacy and community development organizations, academics and researchers, and state regulators.

.34 The focus of the public hearing is to gather information on how to develop rules to stop fraud and abusive practices in the home mortgage market. The rules must be drafted to sharply and clearly avoid the unintended consequence of restricting consumers' access to responsible subprime credit. Several states are expected to participate in the hearing to draft updated rules on predatory lending.

Small Banks Begin to Enter the Mortgage Sector

.35 As reported in the June 22, 2007, edition of *American Banker*, the recent decline of the subprime mortgage sector could allow smaller banks to emerge as players in the mortgage sector. Many of the national and large regional banks are consumed with problems and damage control as a result of risky lending. In the past, this sector was dominated by conglomerate banks.

Subprime Mortgage Update

.36 On May 17, 2007, Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System, commented that the rise in delinquencies among subprime ARMs was due to several causes. These causes include rising interest rates, moderate economic growth, decline in the housing market, and regional economic problems.

.37 Bernanke noted that the practices of several mortgage originators to loosen underwriting standards contributed to the problems in the subprime market. As the underlying pace of mortgage originations slowed but the demand for securities with high yield rates strengthened, some lenders loosened underwriting standards. The loosened standards undoubtedly contributed to defaults occurring within a few months of origination. Bernanke explained that mortgages sold generally pass a large amount of risk to the investor, rather than being borne primarily by the company that originated the loan, which may have contributed to the loosening of underwriting standards. In addition to weakened standards, incentive structures that tied originator revenue to the number of loans finalized, instead of the quality of loans made, are also a cause for concern.

.38 Despite subprime woes, Bernanke indicated that the market had shown signs of self-correction. Although credit spreads on new subprime securities have risen, the volume of subprime mortgage backed securities issued has slowed. That does not mean that the subprime market has evaporated. Although some subprime lenders have gone out of business, other entities such as hedge funds and investment banks have started to purchase subprime mortgage backed securities. Importantly, Bernanke pointed out that the majority of troubled lenders have not been institutions with federally maintained deposits.

.39 Auditors may need special skills or knowledge to plan and perform auditing procedures for institutions that deal with subprime mortgages. This is very important when considering whether an institution has disclosed its subprime lending activities properly. AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), states that for some derivatives and securities, generally accepted accounting principles (GAAP) may prescribe presentation and disclosure requirements. Furthermore, AU section 332 advises the auditor to consider the form, arrangement, and content of the financial statements (including the notes) when evaluating the adequacy of presentation and disclosure. Auditors may also consider using a specialist when determining how to audit an entity that deals in derivatives. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance on the use of a specialist during an engagement.

Subprime Strategies

.40 The rapid growth of subprime mortgages has led to the equally rapid growth of subprime mortgage repossessions. Subprime mortgage repossessions occur when a borrower who is unable to make payments must surrender the mortgage to the lender. There are several strategies that lenders can use to help ensure that they survive subprime meltdown. Examples of subprime strategies include retaining sufficient capital to withstand some subprime turn around; maximizing liquidity and if necessary cutting costs; maintaining a strong credit position; having written plans; and being willing to take action against any broker that puts together fraudulent loans.

.41 There is growing speculation that the problems and risks associated with subprime mortgages, for example, increased risk of past due credit card payments, may spread to other financial transactions. According to a June 25, 2007, article in the *Wall Street Journal* titled "Beyond Subprime, Risks Abound," the bond market is one industry that is already feeling the pressure from subprime mortgages. According to Emerging Portfolio Fund Research Global, investors pulled more than $1 billion out of high yield bond funds in the 2 weeks leading up to the June 2007 article. Another concern is the way ARMs will react as subprime woes continue to trickle down the mortgage industry.

.42 Auditors may consider the overall impact of an entity's portfolio of subprime mortgages when auditing the financial statements of a financial institution. The auditor may consider the institution's internal controls as well as policies that affect the management of subprime mortgages, for instance, the amount reported as the allowance for loan and lease losses.

Subprime Foreclosures

.43 Recently the OCC expressed concern over foreclosures due to subprime mortgages, pointing out that the cost of foreclosure extends not only to the borrower, but also to the local communities that may experience a decline in property value and those in the community who may want to refinance or obtain new financing. Leaving a property vacant during foreclosure can create a negative cycle of disinvestment and lead to decline in an entire community. On June 26, 2007, the OCC released an *Insights* report titled "Foreclosure Prevention: Improving Contact with Borrowers." The report is based on strategies banks are using to prevent foreclosures and mitigate credit loss. The OCC believes that early contact with borrowers is critical to minimizing the detrimental effects of foreclosure. If banks are able to keep homeowners in their homes, they prevent credit losses and maintain customer relationships. Another factor that is helping reduce the number of foreclosures is the use of third parties, such as nonprofits or other interested parties. As a result of third party involvement, many nonprofits are offering counseling services to at-risk homeowners across the nation. The OCC offers three strategies that financial institutions may use to reach borrowers who are behind in their mortgage payments. The first two strategies involve direct customer contact by a loan officer or interested third party, such as a nonprofit counseling agency. The third strategy depends on the borrower using a toll-free telephone number to call the loan servicer or a counseling agency. The full text of this *Insights* report can be accessed at www.occ.treas.gov/cdd/Foreclosure_Prevention_Insights.pdf.

.44 On Sept. 4, 2007, the federal financial institution regulators and the Conference of State Bank Supervisors issued a joint statement on loss mitigation strategies for servicers of residential mortgages. This statement encourages federally regulated institutions and state-supervised entities that service mortgage loans to pursue strategies to mitigate losses while preserving homeownership to the extent possible and appropriate. As a number of adjustable-rate mortgages reset, concerns remain that borrowers subject to these significant payment shocks and increased payments will be more likely to default on the loan.

.45 In the statement, the agencies acknowledge that many subprime and other mortgage loans are sold or transferred, commonly into securitization trusts, with the servicing for these securitized loans maintained by the originating institution. Questions have arisen in recent months on the ability of servicers to restructure loans in jeopardy of foreclosure without nullifying the prior sale for accounting purposes under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. The statement reminds institutions that this authority is governed by the terms of contract documents, typically referred to as pooling and servicing agreements.

.46 This statement urges servicers to use the authority that they have under the governing documents to take appropriate steps when an increased risk of default is identified, including the following:

- Proactively identifying borrowers at heightened risk of delinquency or default, such as those with impending interest rate resets
- Contacting borrowers to assess their ability to repay
- Assessing whether there is a reasonable basis to conclude that default is "reasonably foreseeable"
- Exploring, where appropriate, a loss mitigation strategy that avoids foreclosure or other actions that result in a loss of homeownership

.47 The releases can be found at the FDIC Web site at www.fdic.gov/news/news/financial/2007.

Final Statement on Subprime Lending

.48 On June 29, 2007, the federal financial regulatory agencies (Board of Governors of the Federal Reserve System, FDIC, NCUA, OCC, and OTS) issued the *Statement on Subprime Mortgage Lending* to address issues related to ARMs. The statement can be accessed at www.federalreserve.gov/boarddocs/press/bcreg/2007/20070629/default.htm. The agencies' primary concern is the possibility of "rate or payment shock" to the borrower that may result from the expiration of a fixed introductory rate to an adjustable variable rate for the duration of the loan. The statement is also designed to protect consumers from unfair, deceptive, and other predatory practices and to ensure that consumers are provided with clear and balanced information about the risks of subprime loans.

.49 The statement addresses the need for financial institutions to maintain strong controls to manage the risks associated with these products. Institutions should develop strong controls that monitor whether actual practices are consistent with established policies and procedures. The controls should address compliance and safe guard consumer information concerns. Examples of important controls institutions may adopt include establishing criteria for hiring and training personnel, entering and maintaining relationships with third parties, and conducting ongoing due diligence on third parties.

.50 The statement describes the prudent safety and soundness and consumer protection standards that financial institutions can employ to ensure that loans are made to customers who can afford to make the payments. These standards include a fully indexed, fully amortized qualification for borrowers and cautions on risk-layering features, including an expectation that stated income and reduced documentation should be accepted only if there are documented mitigating factors that clearly minimize the need for verification of a borrower's repayment capacity. Consumer protection standards include clear and balanced product disclosures to customers and limits on prepayment penalties that allow for a reasonable period of time, typically at least 60 days, for customers to refinance prior to the expiration of the initial fixed interest rate period without penalty. It should be noted that there is no supervisory expectation for institutions to waive contractual terms with regard to prepayment penalties on existing loans. The statement reinforces the April 17, 2007, interagency *Statement on Working with Borrowers*, which encouraged institutions to work constructively with residential borrowers who are financially unable or reasonably expected to be unable to meet contractual payment obligations on their home loans. Workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower. Auditors should be aware of and document their understanding of an institution's policies in relation to workout arrangements and potential foreclosures. The auditor should determine if the financial institution is properly disclosing any workout agreements it may have with clients. Auditors may refer to AU section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *Professional Standards*, vol. 1), when considering whether an institution has adequately disclosed the risk of foreclosure as a contingency.

Legislative and Regulatory Developments

Watters v. Wachovia—Where the Supreme Court Decision May Lead U.S. Banks

.51 In an April 2007 decision, the U.S. Supreme Court asserted that the National Bank Act and certain OCC regulations "preempt" state consumer protection laws that subject a national bank's operating subsidy to certain state licensing, reporting, and supervisory requirements. This decision was made even though many in Congress and industry question whether the OCC and OTS are equipped to properly regulate the consumer protection side of business regulation. Federal regulations have, historically, carried an automatic blanket exemption from state consumer protection regulations, and this is an advantage over local banks.

.52 As a result of the decision, state regulators must take a "hands-off" approach when dealing with national bank chains. In addition to that approach, there are questions about what a state can regulate when dealing with the "business of banking." Another interesting consideration is the fact that the OCC and federal courts have not defined what constitutes the business of banking as that business relates to national banks. Readers should remain alert to any developments.

New Regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks

.53 On May 22, 2007, the House of Representatives voted 313 to 104 to approve legislation HR 1427 that would create a new regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Included in the bill was an amendment that forbids government-sponsored enterprises from purchasing mortgages from sellers that do not hold social security numbers. The amendment passed 217 to 205; it is yet to be voted on by the Senate. Readers should remain alert to any developments.

BSA and USA PATRIOT Act Regulations

.54 The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA PATRIOT Act) was passed to strengthen our nation's ability to combat terrorism and prevent and detect money laundering activities in all financial institutions. In March 2006, the USA PATRIOT Act was renewed, making permanent several sun setting provisions, extending two provisions until 2009, and incorporating a number of new right protections. Money laundering provisions of the USA PATRIOT Act described here were made permanent.

.55 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. Discussed in the following paragraphs are sections of the USA PATRIOT Act that directly relate to financial institution practices.

.56 Section 312 of the USA PATRIOT Act requires U.S. financial institutions to establish due diligence policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts of foreign banks and private banking accounts of non-U.S. citizens. On January 4, 2006, FinCEN issued a final regulation implementing Section 312 of the USA PATRIOT Act. The final rule took effect on February 3, 2006, and superseded the interim final rule issued in July 2002. On March 30, 2006, FinCEN extended the applicability date required by the January 4, 2006, final rule from April 4, 2006, to July 5, 2006, for new accounts opened by U.S. financial institutions. The effective date for existing accounts to comply with the January 4, 2006, final rule remains October 2, 2006. Highlights of the final rule include, among other matters, a requirement for U.S. financial institutions to apply due diligence to correspondent accounts maintained for certain foreign financial institutions and private banking accounts maintained for foreign individuals. The rule also establishes scope requirements.

.57 Sections 313(a) and 319(b) of the USA PATRIOT Act add sections 103.177 and 103.185 to the BSA regulations and are intended to prevent money laundering and terrorist financing through correspondent accounts maintained by U.S. financial institutions on behalf of foreign banks. Auditors should be aware of the guidelines as noted in sections 313(a) and 319(b) that do the following:

- Prohibit financial institutions from establishing, maintaining, administrating, or managing a correspondent account in the United States for, or on behalf of, a foreign shell bank.
- Require financial institutions to take reasonable steps to ensure that correspondent accounts of foreign banks are not used to indirectly provide banking services to a foreign shell bank.

- Require financial institutions to maintain records in the United States identifying the owners of each nonpublicly traded foreign bank that maintains an account in the United States and the bank's U.S. agent authorized to accept service of legal process.
- Require financial institutions to close accounts for, and cease transactions with, any foreign bank for which they are unable to obtain the required information or to assure themselves that the correspondent account is not being used to indirectly provide services to a foreign shell bank.
- Require financial institutions to maintain records for five years after an account is closed.

.58 Section 314 of the USA PATRIOT Act adds sections 103.100 and 103.110 to the BSA regulations, which establish procedures that encourage information sharing between governmental authorities and financial institutions and among financial institutions themselves. Section 314 requires a financial institution to do the following:

- Diligently search records and documents to determine whether the institution maintains or has maintained accounts or engaged in transactions with an entity or person listed in a request submitted by the FinCEN. The records search must cover all current accounts, accounts opened in the past 12 months, and financial transactions that occurred in the past 6 months.
- Notify FinCEN if an account or transaction is detected.
- Appoint a contact person.
- Maintain adequate procedures to ensure confidentiality of FinCEN requests.

.59 Section 326 of the USA PATRIOT Act requires the Secretary of the Treasury to jointly prescribe with each of the agencies, the SEC, and the Commodity Futures Trading Commission, a regulation that, at a minimum, requires financial institutions to (1) implement reasonable procedures to 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 the financial institution by any government agency. This final "know your customer" regulation applies to banks, savings associations, credit unions, private banks, and trust companies.

.60 Section 326 also contains procedures for examining each domestic and foreign banking organization's customer identification program (CIP). The procedures are designed to help financial institutions fully implement the new CIP requirements and facilitate a consistent supervisory approach among the federal financial institutions regulatory agencies. On April 28, 2005, the agencies issued *Interagency Interpretive Guidance on Customer Identification Program Requirements*. This was issued to provide interpretive guidance with respect to the CIP rule.

The "Death Penalty Law"

.61 Congress is expected to vote on a new law that many in the banking industry have labeled the "Death Penalty Law." The proposed law gets its name from the nature and severity of punishment if a federally chartered financial institution is convicted of money laundering. If convicted, the financial institution will lose its charter and close. If the institution is state chartered, its insurance coverage will be terminated.

.62 Many top bank executives are lobbying the U.S. Congress in an effort to slow the passage of legislation. This is being done because executives believe the new law creates an unreasonable standard for financial institutions. For more information, access www.bankersonline.com/articles/bhv01n03/bhv01n03a10.html. AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1), provides guidance on the auditor's responsibility when a possible illegal act, for example, an unauthorized transaction, is detected.

Basel II Update

.63 On December 26, 2006, the federal bank and thrift regulatory agencies issued a notice of proposed rulemaking (NPR) seeking comment on possible modifications to the risk based capital standards for all banks, bank holding companies, and savings associations not covered under the risk based capital framework proposed in the Basel II NPR. Comments were accepted through March 26, 2007. It should be noted that Basel II is not all inclusive because it only affects the largest banking institutions.

.64 The federal bank and thrift agencies recommend the following modifications:

- Modernize the risk based capital rules to ensure that the capital framework is able to reliably measure risk in the banking system.
- Mitigate the differences that may arise as a result of differences in capital requirements between banks that adopt Basel II and those banks that continue to apply existing capital rules.
- Ensure that implementation is simple for banks that are subject to the existing risk based capital rules.

.65 This NPR allows banking organizations to early adopt the modifications or remain subject to the agencies' current risk based capital rules. For more information, visit www.fdic.gov/news/news/financial/2006/fil06111.html.

.66 The federal bank and thrift regulatory agencies have also sought comment on proposed guidance describing the agencies' expectations and concerns about the adoption of Advanced Internal Ratings Based (IRB) Approach for credit risk and the Advanced Measurement Approaches (AMA) for operation risk under the Basel II capital framework. The proposed guidance also establishes standards for supervisory review and capital assessment under Pillar 2 of the Basel II framework. Highlights of the proposal are summarized in the following list:

- The proposed guidance is required for banking organizations that implement the proposed Basel II framework.
- The proposed new guidance should provide more direction in instances where prudential issues or industry standardization is of significant importance.
- The guidance should also provide banks with a clear description of the essential components of an acceptable IRB framework.
- The guidance also highlights supervisory standards that banks can follow to implement and maintain an AMA framework for regulatory capital purposes.
- Pillar 2 has three fundamental objectives: comprehensive supervisory assessment of capital adequacy, bank compliance with regulatory capital requirements, and bank implementation of an internal capital adequacy assessment process.
- It is important to note that the proposed guidance should not be construed as the agencies' predisposition of the Basel II NPR.

Banking Agencies Reach Agreement on Basel II Implementation

.67 The Federal Reserve, OCC, OTS, and FDIC reached an agreement regarding the implementation of Basel II in the United States. The agreement resolves the remaining major issues and should lead to finalization of a rule that implements advanced approaches for computing large banks' risk based capital requirements.

.68 The agencies agree that rules implementing the advanced approach should be finalized expeditiously and should be consistent in most regards to international approaches. The agencies also agree that two transition periods will be required to fully implement the rules. Highlights of the agencies' release are included in the following list:

- The agreement retains the NPR's transitional floor periods.
- At the end of the second transition year period, the agencies intend to publish a study that evaluates the new framework to determine if there are any material deficiencies.
- The agencies have agreed to eliminate language in the NPR concerning the 10 percent limitation on aggregate reductions in risk based capital requirements.
- The agencies believe the annual review process is consistent with recommendations of the U.S. Government Accountability Office and that it provides a prudent framework for managing the implementation of Basel II in the United States.
- The agencies also agreed to proceed with the issuance of a proposed rule that would allow all noncore banks to adopt a standardized approach under Basel II. This would eliminate the adoption of Basel 1AA.

Proposed Update of Section 12 of the Code of Federal Regulations 563.81

.69 The OTS recommended a rule change to Section 12 of the Code of Federal Regulations (CFR) 563.81. The proposal serves as a final revision of Section 12 of CFR 563. The final rule updates regulations that require savings associations to obtain approval before they may include subordinated debt securities or mandatorily redeemable preferred stock in supplementary (tier 2) capital. The final rule removes several unnecessary or outdated requirements and conforms other provisions, such as maturity period requirements and purchaser restrictions. The final rule also reconciles conflicting rules, adds appropriate statutory references, and rewrites the rule in plain language. The effective date for the final rule is April 1, 2007.

FDIC Improvement Act Filers

.70 Banking regulators continue to assess the requirements for nonpublic and nonaccelerated FDIC Improvement Act (FDICIA) filers under Part 363 of the FDICIA. FDIC is currently revising Part 363. Readers are advised to monitor the progress of the revision. In anticipation of the changes to Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), the AICPA's Auditing Standards Board (ASB) decided to defer the issuance of the revised AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1), until the PCAOB issued its amendments and the ASB has time to consider them. On July 25, 2007, the PCAOB issued Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), which is effective for audits of internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002 for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted at any point after SEC approval. When Auditing Standard No. 5 becomes effective, it will supersede Auditing Standard No. 2. In the interim, to avoid inconsistencies between AT section 501 and SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which was issued in May 2006, the following conforming changes were made to AT section 501 to bring that standard into conformity with corresponding aspects of AU section 325:

- Deleting the term *reportable condition* and its definition
- Replacing the definition of the term *material weakness*

- Introducing the terms *control deficiency* and *significant deficiency* and their related definitions
- Replacing the guidance on evaluating control deficiencies with the relevant guidance from AU section 325
- Replacing the term *audit committee* with the term *those charged with governance*, defined in AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), to describe the party to whom the practitioner must communicate significant deficiencies and material weaknesses
- Identifying areas in which a control deficiency ordinarily is at least a significant deficiency in internal control
- Identifying indicators of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control
- Requiring the practitioner to communicate to management and those charged with governance, in writing, significant deficiencies and material weaknesses

.71 The ASB conferred with the banking regulators on the decision to temporarily "freeze" the AT section 501 project until the PCAOB completed its revisions to Auditing Standard No. 5. Now that the standard is issued, the AT section 501 task force has resumed its work and plans to issue an exposure draft in late 2007 or early 2008. In the interim, banking regulators have indicated that they will continue to apply their previous guidance to nonpublic FDICIA institutions and nonaccelerated public FDICIA institutions subject to the FDICIA internal control reporting requirements. The FDIC has not issued any official guidance to this effect, but the FDIC's Financial Institution Letter FIL-122-2004, which outlines the requirements for nonpublic and nonaccelerated public FDICIA filers, is relevant. Auditors are urged to consult the FDIC Web site (www.fdic.gov) for official communications.

Reminder of Supervisory Guidance for Financial Institutions Affected by Hurricane Katrina

.72 On February 5, 2007, the FFIEC issued *Reminder of Supervisory Guidance for Financial Institutions Affected by Hurricane Katrina* for immediate release. The intent of the guidance is to remind financial institutions in the U.S. Gulf Coast region that the guidance outlined in Hurricane Katrina Examiner Guidance remains in effect and should be referred to when making decisions regarding payment deferrals, loan refinancing, extensions, restructurings, or other payment programs. Although loan workout programs may involve protracted payment plans, ultimately the loan should be repaid.

.73 The agencies and state supervisory authorities in Alabama, Louisiana, and Mississippi continue to remind financial institutions doing business in the Gulf Coast region that working constructively with borrowers is in the best interest of both the financial institution and the customer.

The SEC's Executive Compensation and Related Person Disclosure

.74 The SEC issued Release No. 33-8732A on August 29, 2006, which adopts amendments to the disclosure requirements for executive and director compensation, related person transactions, director independence, and other corporate governance matters and security ownership of officers and directors. These amendments apply to disclosure in proxy and information statements, periodic reports, current reports, and other filings under the Securities Exchange Act of 1934 and to registration statements under the Securities Exchange Act of 1934 and the Securities Act of 1933. The SEC is also adopting a requirement that disclosure under the amended items generally be provided in plain English. This rule is effective November 7, 2006.

.75 Additionally, on August 29, 2006, the SEC requested additional comments on a proposed amendment to the disclosure requirements for executive and director compensation, which would require disclosure for three additional highly compensated employees. The full text of the release can be viewed at www.sec.gov/rules/proposed/2006/33-8735.pdf.

SEC Disclosure Questions and Answers on Executive Compensation and Related Person Disclosure Transition

.76 Additionally, the SEC has published a set of questions and answers (Q&A) representing the staff's views on questions it has received regarding issuers' transition to compliance with the amendments and new rules adopted by the SEC in the Executive Compensation and Related Person Disclosure rulemaking. The nine Q&A cover the effective date of the new rules and early compliance with the new rules. The Q&A can be found at www.sec.gov/divisions/corpfin/faqs/execcompqa.pdf.

FDIC Rule Revisions

.77 The FDIC issued a final rule repealing Part 349 of the FDIC Rules and Regulations, Reports and Public Disclosure of Indebtedness of Executive Officers and Principal Shareholders to a State Nonmember Bank and Its Correspondent Banks. Auditors should note that repeal of the rule does not eliminate restrictions on loans made to bank executive officers and shareholders. The repeal does eliminate reporting requirements and public disclosure of insider loans.

.78 The FDIC issued a final rule on Part 328 of the FDIC Rules and Regulations, *Advertisement of Membership*. Recent amendments to the Federal Depository Insurance Reform Act of 2005 required the FDIC to prescribe an official sign that all FDIC-insured depository institutions would be required to display. The amended rule accomplishes that requirement and provides for other changes to the regulation.

.79 The FDIC also issued final rules to amend Part 327 of the FDIC Rules and Regulations. The first rule creates a new system for risk based assessments and sets assessment rates as of January 1, 2007. The other rule sets the designated reserve ratio at 1.25 percent. The amendments were made to implement the Federal Depository Insurance Reform Act of 2005. The rules are designed to make the insurance assessment system's reaction to changes in an institution's risk profile more efficient. The final rule took effect January 1, 2007.

.80 On October 16, 2006, the FDIC Board of Directors approved a final rule to implement the One Time Assessment Credit as required by the Federal Depository Insurance Reform Act of 2005. Under the final rule, eligible institutions will share in an aggregated 1-time deposit insurance assessment credit of $4,707,580,238.19. The final rule outlines who is eligible for the 1-time credit as well as the guidelines when applying the credit. The final rule took effect on November 17, 2006.

Revised Interagency Policy Statement on the Allowance for Loan and Lease Losses

.81 The OCC, Board of Governors of the Federal Reserve System, FDIC, OTS, and NCUA have revised the banking agencies' 1993 policy statement on the allowance of loan and lease losses (ALLL).

.82 The agencies' revised their policy in an effort to be more consistent with GAAP and more recent supervisory guidance. The two major revisions to the agencies' 1993 policy statement are as follows:

1. The extension of applicability to credit unions

2. A frequently asked questions section designed to assist institutions in complying with GAAP and ALLL guidance

.83 The revised policy statement applies to all depository institutions (except U.S. branches and agencies of foreign banks) that are supervised by the OCC, Board of Governors of the Federal Reserve System, FDIC, OTS, and the credit unions insured and supervised by the NCUA. U.S. branches and agencies of foreign banks continue to be subject to any separate guidance issued by their respective supervisory agency.

.84 The revised policy reiterates key concepts and requirements included in GAAP and existing ALLL guidance. The principal sources of guidance include FASB Statement Nos. 5, *Accounting for Contingencies*, and 114, *Accounting by Creditors for Impairment of a Loan—an amendment of FASB Statements No. 5 and 15*. The FASB also issued an article that presents Q&A to provide specific guidance on the application of ALLL policy. For more information, please visit www.fdic.gov/news/news/financial/2006/fil06105a.pdf. The FASB is also working on a project to address disclosures related to the allowance for loan losses for financing receivables (loans and finance leases pursuant to FASB Statement No. 13, *Accounting for Leases*). For more information, visit the FASB Web site at www.fasb.org.

.85 Because ALLL represents one of the most significant estimates in a financial institution's financial statements (and regulatory reports), auditors should develop an understanding of the estimation methodology of the institution. It is important to note that the auditor's primary concern is to determine, through audit procedures, that the loan loss estimate is not materially misstated. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors when auditing accounting estimates as described above. AU section 342 details how important it is for the independent auditor to gain an understanding of the methods used by management to make accounting estimates. The section also describes how the auditor might evaluate the reasonableness of estimates during testing.

.86 The auditor typically achieves objectives for auditing the allowances by testing management's estimates of the allowance based on available and relevant information regarding loan collectibility. The auditor is not responsible for estimating the amount of the allowance or ascertaining the collectibility of each, or any, specific loan included in an institution's loan portfolio. However, the auditor's objective of audit procedures for credit losses is to obtain sufficient appropriate audit evidence that the loan loss estimate is not materially misstated. Some questions include the following:

- Are the allowance for loan losses and the allowance for credit losses on off-balance sheet credit exposures reasonably estimated in accordance with GAAP to cover the amount of probable credit losses inherent in the loan portfolio and in off-balance sheet financial instruments, respectively, at the balance sheet date?
- Are controls over the allowance estimation process operating effectively?
- Is the allowance calculation properly documented and in accordance with current accounting and regulatory guidance?
- Are disclosures adequate?
- Is the allowance excessive, or does it imply shortfall?
- Is there directional consistency between credit quality indicators (for example, charge-offs versus delinquencies, and loan-loss provision levels versus allowance levels)?

Commercial Real Estate Update

.87 Major commercial real estate (CRE) sectors include office, hotel, industrial, multifamily, and retail. According to the FDIC, CRE debt measured $3 trillion in the first quarter of 2007, compared to $2.3 trillion in 2006. The real estate industry continues to grow, albeit at a slower rate compared to 2006. The CRE market has maintained its strength despite the consumer housing slowdown.

.88 On December 12, 2006, the FDIC, OCC, and Board of Governors of the Federal Reserve System issued joint *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. The guidance reminds institutions that strong risk management practices and appropriate levels of capital are essential elements of a sound CRE lending program, particularly when an institution has a large concentration in CRE loans. Highlights include the following:

- There is growing concern that rising CRE concentrations may expose the institutions to unanticipated earnings and capital volatility in the event of adverse changes in the general CRE market.
- Guidance issued by the institutions addresses sound risk management practices for concentrations of CRE lending.
- The guidance includes criteria for supervisors, including numerical indicators for institutions with potentially significant CRE loan concentrations that may warrant more scrutiny.
- The guidance is not intended to limit banks' CRE lending because banks serve an important role in their communities by supplying credit for business and real estate development.

CRE Examination Issues and Best Practices

.89 Recently the FDIC issued an article on CRE underwriting and loan administration practices, recurring examination issues, and best practices for managing CRE portfolios in the current business environment. It is important to note that many institutions are experiencing moderate to rapid growth in CRE lending portfolios. As a result, many of the financial institutions consider such portfolios as a viable market niche. Larger financial institutions continue to use pricing advantages over smaller community banks in other areas, such as home equity lines or customer financing. Smaller community banks use their knowledge of the local market and borrowers to compete with the larger institutions.

.90 The FDIC is very concerned about the trends in underwriting and management in CRE lending. During a recent examination, it was noted that the most worrisome findings were a lack of construction supervision, weak appraisal review programs, inadequate knowledge of lending markets, and poor loan structuring. It was also noted that most institutions failed to properly monitor their CRE portfolios properly or failed to comply with the requirements of Part 365 of FDIC Rules and Regulations, *Real Estate Lending Standards*.

.91 Although many institutions have increased their exposure to CRE lending risks, they have not implemented an adequate monitoring system. Some institutions did not know what percentages of their CRE portfolio investments were concentrated as low, moderate, or more risky. Common monitoring deficiencies include failure to do the following:

- Establish exposure limits
- Prepare reports that provide sufficient relevant information
- Prepare timely concentration reports
- Track exceptions
- Track aggregate loan amounts
- Consider commitment amounts when computing loan to value limits

.92 FDIC examiners also feel that many institutions overlook the importance of market analysis. In some cases, the examiners determined that institutions had not bothered to perform market analysis of key lending areas. It was also noted that loan to value limits were not established as a supervisory tool. There were a number of instances noted by the examiners of loans structured with weak or lenient loan terms. Conditions included the following:

- Over-reliance on collateral values instead of cash flow
- Liberal use of interest or other reserves

- Loans with balloon maturities secured by undeveloped land
- Letters of credit and unsecured loans granted for the purpose of investing in real estate developments (primarily in the Southeastern United States)

.93 Lastly, examiners noted that many institutions did not maintain proper oversight over the appraisal process. The following findings were noted during the examination:

- Missing or incomplete internal reviews of appraisals
- Inadequate appraisals or violations of FDIC Rules and Regulations concerning appraisals
- Loan funding prior to receipt and review of appraisals
- Including the proposed loan amounts on appraisal engagement letters
- Extending funds to customers based on future gross sell-out values of real estate projects

.94 Although the examiners noted several deficiencies, they also discovered several "best practices" that institutions may consider implementing to control their CRE lending portfolios. Examples of the best practices are as follows:

- The Board of Directors should approve the scope of lending activities and the way real estate loans are processed, serviced, and collected. Market conditions, concentrations, and lending activity should be monitored on a consistent basis, with timely and adequate reports made to the Board of Directors.
- Internal and external factors should be considered during the formation of loan policies. Examples of factors to consider include the organization's size, strategic plan, and the expertise of the institution's staff.
- Prudent underwriting standards should be developed. The standards should consider the capacity of the borrower and the income from the underlying property to service the debt.
- Lending policies should reflect the level of risk that is acceptable to the institution's Board of Directors. Clearly measurable limits that include maximum loan amounts, maturities by type of property, amortization schedules, pricing structure, and loan to value limits should be reflected.
- Loan administration policies and procedures should address the type and frequency of financial statements required based on the type of loan. Collateral evaluations, adequate construction inspections, and other requirements may also be useful.

.95 Historically, financial institutions have generally suffered severe losses as a result of the loss of expected cash flows due to loan defaults and inadequate collateral. For example, significant credit losses on real estate loans have occurred, due largely to downturns in regional and national real estate markets but also because of other general economic conditions and higher risk lending activities. Therefore, the auditor needs to assess the existence, valuation, and ownership of the collateral supporting the client's receivables and to determine if the internal control systems have been properly designed and are effective. The auditor can observe the CRE lending at the client and plan accordingly. Some issues auditors may want to consider include, but are not limited to, those described in the following sections.

.96 Certain real estate loan arrangements, in which the lender has virtually the same risks and potential rewards as those of the owners of the property, should be classified and accounted for as investments in real estate and not CRE loans. Certain acquisition, development, and arrangements should be accounted for as investments in either real estate (in conformity with FASB Statement Nos. 66, *Accounting for Sales of Real Estate*, and 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*) or real estate joint ventures (in conformity with the provisions of Statement of Position [SOP] 78-9, *Accounting for Investments in Real Estate Ventures* [AICPA, *Technical Practice Aids*, ACC sec. 10,240]; FASB Staff Position [FSP] SOP 78-9-1, "Interaction of AICPA Statement of Position 78-9 and EITF Issue No. 04-5;" Emerging Issues Task Force [EITF] Issue No. 04-5, "Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights;" and FASB Statement No. 34, *Capitalization of Interest Cost*, as amended by FASB Statement No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*). Additionally, provisions of FASB Interpretation No. (FIN) 46(R), *Consolidation of Variable Interest Entities (revised December 2003)*, should be considered for real estate held joint ventures or partnerships. FIN 46(R) clarified the application of Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, to certain entities in which equity investors do not have the characteristics of a controlling interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support.

.97 The federal banking and thrift agencies and the NCUA require real estate appraisals for properties over defined limits. Many fair values will be based on valuations by independent appraisers.[2] In applying audit procedures to real estate loans, the independent accountant can evaluate the fair value of the underlying collateral (including those held for sale) and note contents of loan files that include collateral description and valuation. The auditor often relies on representations of independent experts, particularly appraisers and construction consultants, to assist in the assessment of real estate collateral. AU section 336 provides guidance in this area. Independent appraisals may be considered acceptable audit evidence. The quality of appraisals varies, however, and in some instances, the independent accountant may have reason to believe certain assumptions underlying appraisals are unrealistic. The independent accountant needs to understand and consider the approaches and assumptions used in obtaining the appraised value. The current downturn in the real estate market increases audit risk surrounding the valuation of receivables; the institution will have to absorb losses between actual and appraised values if credit quality deteriorates and borrowers default.

.98 Additionally, AU section 342 provides guidance on auditing accounting estimates (such as estimates of fair values, discussed previously, and estimates of loan losses). AU section 342 discusses how an independent accountant obtains an understanding of how management developed estimates, concentrating on the key factors and assumptions used. It also discusses how the independent accountant evaluates the reasonableness of those estimates. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), establishes standards and provides guidance on auditing fair value measurements and disclosures contained in financial statements.

.99 Auditors should note management's general attitude toward CRE lending policies when considering an institution's internal controls. Strong CRE lending policies and a diligent Board of Directors could assist the independent auditor when assessing control risk. Auditors should refer to AU sections 314 and 318 for guidance when considering an entity's internal controls. Auditors should also consider management's attitude toward CRE lending policies and internal controls as they relate to the management representation letter. For guidance on management representations, auditors should refer to AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1).

Market Risk Capital and the Applicability of Market Risk Capital Rules

.100 The July 18, 2007, edition of the Financial Institution Letter (FIL-64-2007) reminds financial institutions that reporting a significant amount of trading assets on the institution's balance sheet or increasing the percentage of assets reported as trading may subject that institution to the market risk capital requirements of Part 325, Appendix C of the FDIC's Rules and Regulations. This rule applies to banks with trading activity of $1 billion or more, or at least 10 percent or more of total assets. Trading activity is usually reported on an institution's quarterly call report.

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[2] On June 22, 2006, the Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, Office of Thrift Supervision, and National Credit Union Administration released an interagency statement and frequently asked questions regarding revisions made to the Uniform Standards of Professional Appraisal Practice (USPAP). Under the agencies' appraisal regulations, regulated institutions must ensure that appraisals supporting federally related transactions adhere to USPAP. The interagency statement provides an overview of the USPAP revisions and the ramifications of these revisions to regulated institutions' compliance with the agencies' appraisal regulations.

.101 Financial institutions should be aware of the implications and potential impact of FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. Application of FASB Statement No. 159 could result in institutions meeting the market risk capital requirements. The market risk capital rules require institutions to have certain risk management systems in place prior to the performance of any trading activity that is above $1 billion or at least 10 percent of total assets. Institutions that are subject to market risk capital requirements are required to measure their market risk using value-at-risk models. In addition to risk management systems, institutions should contact the FDIC in preparation for compliance with the market risk capital requirements.

.102 Auditors should consider the institution's risk management systems and controls if the institution meets the market risk capital requirements as outlined in Appendix C of the FDIC's Rules and Regulations. The auditor may inquire about the institution's risk management systems when considering the entity's internal controls. The auditor should consider whether the entity's risk management systems can be circumvented by collusion or fraud. AU sections 314 and 318 may provide some guidance when considering the entity's risk management systems. Auditors may also consider using a specialist if the institution is implementing the capital risk requirements for the first time. AU section 336 may provide guidance for the auditor considering the use of a specialist.

Audit and Attestation Issues and Developments

Fraud in the Industry

Money Laundering

.103 The U.S. Departments of Treasury, Justice, and Homeland Security joined together in issuing the 2007 National Money Laundering Strategy, a report detailing efforts to dismantle money laundering rings and terrorist financing networks and bring these criminals to justice. The 2007 strategy is based on data and analysis from the 2006 Money Laundering Threat Assessment.

.104 The 2007 strategy builds on initiatives and programs pioneered in preceding National Money Laundering Strategies. The Assistant Attorney General believes that implementation of a sound strategy is the key to success in the fight against money laundering and that constant searching by criminals for new ways to launder and hide dirty money is evidence of successful regulatory and law enforcement efforts to safeguard the banking system. With an aim at continuing these robust efforts, the 2007 strategy places an emphasis on bolstering the efficiency of the anti-money laundering processes currently in place.

.105 The 2007 strategy focuses on leveling the playing field internationally, helping to ensure that U.S. financial institutions are not disadvantaged through the implementation of controls and standards to combat money laundering and terrorist financing. Indeed, money laundering is a global threat that the United States is working to address through international bodies, including the Financial Action Task Force, and through direct private sector outreach in regions around the world. More information is available at www.treas.gov/press/releases/hp386.htm.

.106 When obtaining an understanding of a financial institution's internal control system, auditors may consider controls that focus on money laundering. AU sections 314 and 318 provide guidance on an independent auditor's consideration of an entity's internal control in an audit of financial statements.

Mortgage Fraud

.107 Lower interest rates helped create the housing boom of the early 2000s. Consumers and investors took advantage of lower interest rates to purchase, upgrade, or invest in the real estate market. To keep up with demand and work with borrowers, certain financial institutions created new, nontraditional mortgage products that increased the dollar amount of mortgage individuals who were willing to finance to purchase real estate. In effect, the products turned the real estate market into a "golden egg" search as investors armed with excess capital searched for investments.

.108 The new mortgage products also opened the door for unscrupulous individuals who figured out ways to manipulate circumstances to their advantage. For example, a mortgage broker could bundle several subprime mortgages and sell them to an unsuspecting buyer. Another example of fraud in the mortgage industry is the use of false property appraisals.

.109 In the spring of 2007, the FBI had 1,036 pending mortgage fraud investigations, a substantial increase compared to prior years. Most types of mortgage fraud fall into two categories:

- Fraud for property that typically involves a borrower who will overstate income or asset values on his or her financial statement to qualify for a property loan. When the borrower fails to met the mortgage payment, he or she sells the property at a profit based on appreciation.
- Fraud for profit that involves complicated schemes and is generally harder to detect. These types of fraud usually involve several members, including some insiders.

.110 In addition to understanding the client and proper audit planning, auditors should be alert for possible indicators that could be signs of fraud. In performing the audit, auditors should consider whether the institution has done the following:

- Established a system to monitor concentration of risk by broker and project
- Performed internal audits of loan origination documentation
- Established clearly defined quality control programs
- Established dual controls over loan origination and fund disbursement
- Conducted background checks on new employees
- Provided ongoing employee training and oversight

.111 AU sections 314 and 318 require the auditor to obtain an understanding of internal control that will enable the auditor to identify the types of potential misstatements of management's assertions, consider factors that affect the risk of material misstatement, design tests of controls where applicable, and design substantive tests. As the auditor gains an understanding of an entity's internal control, he or she may determine areas where fraud could occur. See AU section 316 for guidance on fraud related issues when conducting a financial statement audit. AU section 317 may also be useful to auditors when conducting an audit of an institution's financial statements. Auditors should also consider management's attitude toward CRE lending policies and internal controls as they relate to the management representation letter. For guidance on management representations, auditors should refer to AU section 333.

Revised Bank Secrecy Act/Anti-Money Laundering Examination Manual

.112 On August 24, 2007, the FFIEC released the revised Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual (manual). The revised manual reflects the commitment of the federal and state banking agencies and the FinCEN to provide consistent guidance on risk based policies, procedures, and processes for banking organizations to comply with the BSA and safeguard operations from money laundering and terrorist financing. The 2007 edition clarifies supervisory expectations since the July 28, 2006, update.

.113 On November 9, 2006, FinCEN released an advisory to alert financial institutions of some of the potential money laundering risks associated with providing financial services to shell companies. Although many shell companies are formed for legitimate reasons, others have been used for illicit purposes. Shell companies provide an opportunity for foreign or domestic entities to move money by wire transfer or other methods, whether directly or through a correspondent banking relationship, without company owners disclosing their true identities or the nature of the transaction. Billions of dollars have been moved globally by shell companies. Banks often face the following challenges when filing suspicious activity reports involving shell companies:

- Inability to obtain information necessary to identify originator or beneficiaries of wire transfers
- Payments that do not state a specific purpose or contract number
- Multiple high volume payments or transfers between shell companies with no apparent legitimate business purpose
- An unusually large number and variety of beneficiaries that receive wire transfers from one company
- Goods or services listed on transfer reports that do not match the industry in which the entity works

.114 To safeguard against the risk of money laundering by shell companies, financial institutions should assess the risks involved with each shell company relationship and take steps to ensure that the risks are appropriately and effectively identified and managed in accordance with their BSA obligations. All financial institutions should periodically evaluate internal policies, controls, systems, and training programs designed to prevent, detect, and report possible money laundering involving shell companies. Auditors may consider documenting the controls an entity has in place concerning money laundering and other suspicious activity when documenting their understanding of internal controls. See AU sections 314 and 318 for 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).

.115 On July 13, 2007, FinCEN issued guidance for financial institutions with account relationships that law enforcement may have an interest in ensuring remain open, notwithstanding suspicious or potential criminal activity in connection with the account. The intent of the guidance is to combat money laundering terrorist financing and other crimes. FinCEN acknowledges that the right to open or close an account remains with each financial institution, each using their standards and policies.

.116 When a law enforcement agency requests that an account remain open, it should be in writing. The requests should come from the U.S. Attorneys Office or be issued by a supervisory agent. The written request should indicate that the agency has requested the account remain open and the purpose of the request. The request should also state the duration for which the account should remain open, which should not exceed six months. Although there is no record keeping requirement under the BSA for this type of correspondence, FinCEN recommends that financial institutions maintain such requests. If the financial institution is aware that the account is under investigation, FinCEN recommends the institution contact law enforcement before making any decision regarding the status of the account. Auditors should be aware of the institution's policies, procedures, and processes that address identification of suspicious activity in accordance with the BSA/AML compliance program.

.117 On June 22, 2007, the FDIC Chairman applauded FinCEN for addressing the need to tailor administration of the BSA to the many different risk profiles of community banks. The Chairman welcomed the continued opportunity to continue working with FinCEN and other regulatory agencies to ensure that BSA guidance and procedures are efficient and effective for all banks.

.118 Financial institutions often face common problems when it comes to the BSA. Examples include a lack of written policies, failure to conduct periodic transaction reviews in a timely matter, lack of an independent and sufficiently knowledgeable reviewer, and failure to include overall integrity of the program within the review.

Third Party Risks

.119 The FDIC is increasingly concerned with the use of third party entities that act as agents between consumers and financial institutions, especially community banks. Although third party entities can provide a valuable service to consumers and financial institutions, they can also increase the risk faced by the financial institutions. Successful third party relationships start with understanding of potential risks and proper strategic management. For example, a team of risk management examiners could discover suspicious activity reports during an engagement. The information and evidence they uncover could also provide evidence of unfair or deceptive practices. That evidence could be very useful to compliance auditors.

.120 The term *third party* is broadly defined to include any entity or individual that has entered into a business relationship with an insured depository institution. Examples of third parties include banks (affiliated or not), a regulated institution, and a nonregulated institution, foreign or domestic. Third parties are usually deeply involved in the delivery of financial services to the consumer. The third party can be positioned either directly or indirectly between the financial institution and the consumer. The FDIC is concerned that the use of third parties in financial transactions increases the level of risk for financial institutions and creates potential adverse effects for consumers. The FDIC believes that third party risks transcend all examination disciplines and necessitate close communication between examination teams.

.121 As the role and scope of financial services expands, so to does the role of the third party. Listed below are some pervasive examples of services provided by third parties. Auditors should be aware and document these relationships when performing an audit:

- Perform functions on the institution's behalf.
- Provide customer access to various products and services.
- Increase the financial institution's revenue through the third party's products, such as loan review or asset and liability management.

.122 Some of the risks associated with third party involvement are based on the underlying activity itself, for example, helping consumers secure loans. Other types of risk associated with third party involvement are less noticeable. It is important to remember that a more complex financial service has the potential to increase third party risk. Third party risk is described in the following broad categories:

- Strategic risk is described as the risk that arises from ill-advised business decisions or the failure to implement consistent business strategies that could mitigate potential risk. In general, financial transactions should provide a return commensurate with the level of risk they expose the financial institution to.
- Reputation risk is the risk of negative public perception that is often caused by breaches in institution policy or standards. Negative publicity from a third party, even one not involved with the institution, can be harmful.
- Transaction risk is the risk that the institution will not be able to deliver products and services to the customer. Auditors should be aware of weak controls that could affect the institution's ability to conduct business.
- Credit risk is the risk that a third party or other creditor necessary to the third party relationship is unable to comply with the terms of the contractual agreement. Auditors may examine documents that confirm the institution monitors third party activities to ensure that credit risk is understood and is within established limits.
- Compliance risk is the risk that the institution or other third party is not in compliance with the rules, laws, regulations, and internal policies of contractual obligations. Company oversight serves as a key control for compliance risk.

- Other risks include liquidity, interest rate shifts, rapid price changes, and foreign currency rate changes. Before an institution enters into a third party relationship, it is important for the institution to consider potential risks.

.123 Each institution's audit department should provide comprehensive, independent reviews of all third party arrangements, as well as any underlying activities. Findings should be presented to the institution's Board of Directors as soon as possible to ensure that appropriate action is taken. During an audit of a financial institution that conducts transactions with third parties, auditors should evaluate the results of audit procedures carefully. The auditor may encounter specific information that may raise questions concerning possible illegal acts. AU section 317 lists the following as examples of possible illegal acts:

- Unauthorized transactions or improperly recorded transactions
- Unusual payment of fines or penalties to government or regulatory entities
- Large payments to consultants, affiliates, or employees
- Excessive sales commissions or agent fees
- Unexpected payments made to government officials
- Failure to file tax returns or pay government duties or similar fees that are common in the financial industry

.124 Furthermore, AU section 317 states that auditors who become aware of information concerning a possible illegal act should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effects on the financial statements. The auditor should contact management one level above those involved. Based on the results of the additional testing and the responses from management one level higher than those involved, the auditor may be forced to issue a qualified or even an adverse audit opinion.

.125 AU section 326, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1), states the auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit. Auditors should be aware of the institution's third party arrangements and test them to support their audit opinion.

Accounting Issues and Developments

FASB Statement No. 157

.126 In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, to provide enhanced guidance for using fair value to measure assets and liabilities. This statement defines fair value and expands disclosures about fair value measurements. The statement applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The statement does not expand the use of fair value in any new circumstances.

.127 Prior to this statement, there were different definitions of fair value, and guidance for applying those definitions was dispersed among many accounting pronouncements. Difference in the existing guidance created inconsistencies that added to the complexity in applying GAAP. FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. Readers can access the full text of FASB Statement No. 157 on the FASB's Web site at www.fasb.org. The following items are common areas in a financial institution that may be affected by FASB Statement No. 157:

- Other real estate (required to be carried at lower of cost or fair value less costs to sell)
- Loans evaluated under FASB Statement No. 114 (observable market price or the fair value of collateral)
- Loans held for sale
- Interest rate lock commitments
- Derivatives
- Intangibles and goodwill
- Assets acquired and liabilities assumed in purchased business
- Securities
- Servicing rights (SRs)
- Branches held for sale
- FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, footnote disclosures

FASB Statement No. 159

.128 Subsequent to the issuance of FASB Statement No. 157, the FASB issued FASB Statement No. 159. This statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The statement permits an entity to elect the fair value option on an instrument-by-instrument basis, and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement Nos. 107 and 157.

.129 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157. The choice to adopt early should be made within 120 days of the beginning of the fiscal year of adoption (for calendar year end entities, by April 2007), provided the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year of adoption. The FASB and SEC have expressed concern in the way some early adopters have applied the transition provisions of the standard. The AICPA Center for Audit Quality (CAQ) issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard such as this is applied in a good faith manner consistent with those objectives and principles. Specifically the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB's Web site at www.fasb.org.

SOP 07-01, *Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*

.130 In June 2007, the Accounting Standards Executive Committee (AcSEC) issued SOP 07-01, *Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (AICPA, *Technical Practice Aids*, ACC sec. 10,930). The SOP provides guidance for auditors when trying to determine whether an entity is within the scope of the AICPA Audit and Accounting Guide Investment Companies. In addition, the SOP also contains disclosure requirements for parent companies and equity method investors in investment companies that retain investment company accounting in the parent company's consolidated financial statements or the financial statements of an equity method investor. The SOP is effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged.

FASB Interpretation No. 48

.131 FIN 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

.132 The evaluation of a tax position in accordance with this interpretation is a two-step process. The first step is recognition. The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement. A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

.133 Differences between tax positions taken in a tax return and amounts recognized in the financial statements will generally result in one or both of the following:

1. An increase in a liability for income taxes payable or a reduction of an income tax refund receivable
2. A reduction in a deferred tax asset or an increase in a deferred tax liability

.134 An enterprise that presents a classified statement of financial position should classify a liability for unrecognized tax benefits as current to the extent that the enterprise anticipates making a payment within one year, or within the operating cycle if it is longer. An income tax liability should not be classified as a deferred tax liability unless it results from a taxable temporary difference (that is, a difference between the tax basis of an asset or a liability as calculated using this interpretation and its reported amount in the statement of financial position). This interpretation does not change the classification requirements for deferred taxes.

.135 Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in FASB Statement No. 109 is not an appropriate substitute for the derecognition of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on the sufficiency of future taxable income is unchanged by this interpretation.

FSP FIN 48-1, "Definition of Settlement in FASB Interpretation No. 48"

.136 On May 2, 2007, the FASB issued FSP FIN 48-1, "Definition of Settlement in FASB Interpretation No. 48." This FSP amends FIN 48 to provide guidance on how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits.

.137 Specifically, the FSP amends FIN 48 to clarify that a tax position could be effectively settled upon examination by a taxing authority. Assessing whether a tax position is effectively settled is a matter of judgment. When making a settlement determination, an enterprise should make a position-by-position assessment for all positions in a particular tax year.

.138 The guidance outlined in the FSP shall be applied upon the initial adoption of FIN 48. An enterprise that applied FIN 48 in a manner consistent with the provisions of this FSP would continue to apply the provisions in this FSP from the date of initial adoption of FIN 48. An enterprise that did not apply FIN 48 in a manner consistent with this FSP is required to retrospectively apply the provisions in this FSP to the date of the initial adoption of FIN 48.

.139 To help financial statement preparers, auditors, and tax advisers meet this new requirement, the Accounting Standards, Auditing and Attest Standards, and Tax Teams have developed a practice guide on accounting for uncertain tax positions under FIN 48. Tax positions can only be recognized if they meet a more-likely-than-not threshold of being realized if challenged by a taxing authority with full knowledge of the facts. If this level of certainty is not met, no tax benefit can be booked. Even if it is met, only the amount that has a greater than 50 percent chance of being sustained may be booked. Specific financial statement disclosures are required with respect to uncertain tax positions. The AICPA's 13-page practice guide includes highlights of FIN 48 and its implications for in-house accountants, auditors, and tax advisers. It is not authoritative but is intended to assist members in quickly understanding the requirements of FIN 48. The practice guide is available without charge to all AICPA members. For more information, please visit the AICPA Web site at www.aicpa.org.

Deferred Acquisition Costs on Internal Replacements

.140 In September 2005, AcSEC issued SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications of Exchanges of Insurance Contracts* (AICPA, *Technical Practice Aids*, ACC sec. 10,920). The SOP provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically outlined in 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*. This SOP was effective for internal replacements occurring in fiscal years beginning after December 15, 2005, with earlier adoption encouraged. Retrospective application to previously issued financial statements is not permitted.

Request to Withdraw SEC SAB No. 105

.141 SAB No. 105, *Application of Accounting Principles to Loan Commitments*, was released in 2004 to address questions about the proper valuation of loan commitments that are derivatives under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by FASB Statement No. 149, *Amendment to Statement 133 on Derivative Instruments and Hedging Activities*. SAB No. 105 intends to prohibit entities from incorporating expected future cash flows related to the associated servicing on a loan underlying a derivative loan commitment, or any other internally developed intangible asset, in valuing a commitment.

.142 The MBA believes that the release of FASB Statement No. 159 broadens the scope of SAB No. 105 by permitting entities to report nonderivative loan commitments at fair value beginning in 2008 for most companies. This includes commitments to originate nonmortgage loans. There is also the belief that many people may undoubtedly conclude that SAB No. 105 correctly applies GAAP to derivative loan commitments; therefore, it must also be correct to apply the SAB to other loan commitments, regardless of the fair value guidance of FASB Statement No. 157.

.143 Because FASB Statement No. 157 requires reporting entities to incorporate the cash flows that market participants would consider in pricing loan commitments, which is contrary to the guidance in SAB No. 105, an entity's valuation models produce more accurate representations of fair values of loan commitments than would be true if the cash flows were excluded. Based on this belief, the MBA believes the SAB should be withdrawn as soon as possible to avoid the risk of widespread confusion in implementation of FASB Statement Nos. 157 and 159. On July 6, 2007, the MBA formally requested a meeting with the SEC to discuss withdraw of SAB No. 105. Auditors and banking professionals should monitor this situation.

Securitization and Sale of Nontraditional Products

.144 Higher yielding nonconforming or nontraditional products as well as subprime loans are being securitized and sold in the secondary market. Upon securitization, derivatives are being added to make the securities more attractive to investors. Auditors need to carefully evaluate those derivatives to see whether they qualify as passive derivatives permitted for a qualifying special-purpose entity (QSPE) under FASB Statement No. 140. Note that FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*, amended FASB Statement No. 140 to eliminate the prohibition on a QSPE from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. For additional information, see the section of this alert titled "Changes to FASB Statement No. 140."

Obtaining Legal Opinions

.145 Increased numbers of securitizations means an increased need for legal opinions. Paragraph 27 of FASB Statement No. 140 states that "[t]he nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or SPE might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law." After the issuance of FASB Statement No. 140, the ASB issued Interpretation No. 1, "The Use of Legal Interpretations As Audit Evidence 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 AU section 336. Readers may wish to refer to that auditing interpretation when evaluating the need to obtain a legal opinion.

Changes to FASB Statement No. 140

.146 Effective for fiscal years starting subsequent to September 15, 2006, with early application permitted in certain cases, FASB Statement No. 140 has been amended by two new FASB Statements, FASB Statement Nos. 155 and 156, *Accounting for Servicing of Financial Assets*. Another exposure draft, *Accounting for Transfers of Financial Assets*, will also affect FASB Statement No. 140 and is expected to be issued during the fourth quarter of 2007.

.147 FASB Statement No. 155 amends FASB Statement No. 133 to permit fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation and clarifies which interest-only strips and principal-only strips are not subject to FASB Statement No. 133 requirements. Consequently, the statement resolves issues surrounding FASB Statement No. 133's Implementation Issue No. D1, "Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," and amends FASB Statement No. 140 in the process.

The Old FASB Statement No. 140	*FASB Statement No. 155 Influence*
Paragraphs 35(c)(2) and 40	Amended by paragraphs 4 and 5 of FASB Statement No. 155

Background. Derivatives Implementation Group (DIG) Implementation Issue No. D1 allowed a temporary exemption for derivative accounting for beneficial interests in QSPEs and stated, "Holders of beneficial interests in securitized financial assets that are not subject to paragraph 14 or paragraph 362 of FASB Statement No. 140 are not required to apply FASB Statement No. 133 to those beneficial interests until further guidance is issued."

FASB Statement No. 140 Prohibition. The old FASB Statement No. 140 prohibited a QSPE from holding a derivative financial instrument that pertained to a derivative beneficial interest (or a beneficial interest that included an embedded derivative).

Why? Before the prohibition, the Implementation Issue No. D1 temporary exemption discussed above allowed entities to circumvent derivative accounting by transferring derivatives or hybrids into QSPEs.

FASB No. 155 Amendments to FASB No. 133.

- Amends paragraph 14 to eliminate the temporary exemption for interests in securitized financial assets provided by Implementation Issue No. D1. (Prospective application required: Implementation Issue No. D1 guidance remains effective for instruments recognized prior to the effective date of FASB Statement No. 155.)
- Amends paragraph 14 to require interest holders to evaluate whether instruments are freestanding derivatives or a hybrid financial instrument subject to FASB Statement No. 133 bifurcation requirements.
- Amends paragraph 14 to clarify that concentrations of credit risk in the form of subordination are not embedded derivatives. This is important because if redistributed credit risk constituted an embedded derivative, many securitizations would have been affected.

Amendment to FASB Statement No. 140. Amends paragraphs 35 and 40 of FASB Statement No. 140 to eliminate the prohibition. Because the Implementation Issue No. D1 temporary exemption was eliminated, the prohibition is no longer necessary because each interest holder needs to evaluate whether instruments are freestanding derivatives or hybrid financial instruments subject to FASB Statement No. 133 bifurcation requirements. Evaluation of all potential derivative instruments categories in securitizations is now captured. Because securitizations provide many ways to redistribute to investors the cash flows of the underlying assets, the potential exists for many securitization interests to be hybrid financial instruments.

FASB Statement No. 133 contains an impracticability exception, which FASB Statement No. 155 retained. (If an entity is unable to reliably identify and measure an embedded derivative that must be bifurcated, the entire contract must be measured at fair value with changes in fair value recognized in earnings. Although this exception has been used rarely, it may now be used more frequently due to the complexity of instruments that will no longer receive the temporary exemption under Implementation Issue No. D1.)

.148 FASB Statement No. 156 also amends FASB Statement No. 140 with respect to the accounting for the servicing of financial assets. FASB Statement No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract. The statement also requires that all separately recognized SRs be initially measured at fair value, if practicable. For each class of separately recognized servicing assets and liabilities, the guidance permits an entity to choose either of the following subsequent measurement methods: (1) the amortization of servicing assets or liabilities in proportion to and over the period of estimated net servicing income or net servicing loss or (2) the reporting of servicing assets or liabilities at fair value at each reporting date and reporting changes in fair value in earnings in the period in which the changes occur. The guidance also requires additional disclosures for all separately recognized SRs.

.149 Concepts surrounding FASB Statement No. 156 changes to FASB Statement No. 140 are summarized below. Not all changes are included. For complete guidance, refer to the standard.

The Old FASB Statement No. 140	*FASB Statement No. 156 Influence*
Paragraph 10 states, "Upon *completion* of any transfer (including sales)"	Amended by paragraph 4(c) of FASB Statement No. 156
Continue to carry in the statement of financial position any retained interest in the transferred asset, including *servicing assets*, beneficial interests in assets transferred to a QSPE in a securitization, and retained undivided interests.	Initially recognize and measure at *fair value*, if practicable servicing assets and servicing liabilities that require recognition under the provisions of paragraph 13.
Allocate 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.	Allocate the previous carrying amount between the assets sold, if any, and the interests that *continue to be held by the transferor*, if any, based on their relative fair values at the date of transfer. Continue to carry in the statement of financial position any interest it continues to hold in the transferred assets, including, if applicable, beneficial interests in assets transferred to a QSPE in a *securitization* and any *undivided interests.*
Paragraphs 11 and 56, "Sales" (other paragraphs are involved as well.)	Amended by paragraph 4(d) and 4(j) of FASB Statement No. 156
Describes sale treatment. Derecognize all assets sold and recognized all assets obtained and liabilities incurred. SRs are recorded at allocated carrying amounts and treated as retained interests in transferred assets; hence the term *retained interest* is used.	Adds servicing assets to the definition of proceeds. The proceeds from a sale include SRs. Therefore, the gain or loss on sale is altered by the value of the SR and depends in part on both (*a*) the previous carrying amount of the financial assets involved in the transfer, allocated between the assets sold and the retained interests that continue to be held by the transferor based on their relative fair value at the date of transfer, and (*b*) the proceeds received. The phrase *interests that continue to be held by the transferor* has replaced the term *retained interest* throughout FASB Statement No. 140. FASB Statement No. 156 requires SRs to be initially recorded at fair value and treated as sale proceeds, if applicable, not as retained interests.

The Old FASB Statement No. 140	*FASB Statement No. 156 Influence*
Paragraph 13, "Recognition and Measurement for Obligations Undertaken"	Amended by paragraph 4(e) and 4(f) of FASB Statement No. 156
For transfers/sales, recognize SRs unless the assets were transferred to a QSPE in a guaranteed mortgage securitization, and all resulting securities are retained and classified as held to maturity debt under FASB Statement No. 115. To recognize servicing rights, use the relative allocation method at the date of obligation and amortize using the amortization method only. *For purchases/assumptions*, the SRs should be initially measured at fair value, presumptively at the price paid and then subsequently value the right using amortization method only.	*For all situations*. Always initially value servicing rights at fair value, if practicable. This includes all transfers (accounted for as sales), transfers of financial assets to QSPE in a guaranteed mortgage securitization in which the transferor retains all securities and classified them as available for sale or trading; or purchases/assumptions (transactions that do not relate to financial assets of the servicer or its consolidated affiliates). Paragraph 13 is also amended to discuss the new choice of two methods for subsequent valuation, the fair value method, and the former amortization method.
Paragraph 17, Overview of Disclosures (Description not inclusive)	Amended by paragraph 4(h) of FASB Statement No. 156 Overview (Description not inclusive)
• Collateral disclosures • For SR under amortization method (only method allowed) — Disclose SR recognized and subsequently amortized (only method allowed). — Disclose fair value of recognized SRs and fair value methodology. — Disclose valuation allowance activity. — Disclose risk characteristics of the underlying financial assets used to stratify SRs for purposes of measuring impairment.	• Collateral disclosures are unchanged. • For SR under amortization method, similar disclosures to column one. (However, note that disclosures surrounding the activity for each class and respective location of income statement changes, as well as valuation techniques, are now required.) • New for SR under fair value method: — Activity for each class and where the changes are reported in the income statement. — Description of valuation techniques or other methods used to estimate fair value of each class. — Fair value for each class at beginning and end for each class measured under the amortization method. • New for both methods: — Management's basis for determining its classes of servicing assets/liabilities (relates to the choice of two subsequent valuation methods per paragraph 13A). — Amount of fees earned each period. — Disclosure surrounding inherent risks of SRs and instrument used to mitigate fair value income statement effects.

FASB Projects Updates for FASB Statement No. 140

.150 The FASB issued proposed FSP FAS 140-d, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions," on July 24, 2007. The objective of the proposed FSP is to provide implementation guidance on whether there are circumstances that would permit a transfer of a financial asset separately from repurchase financing. A repurchase financing is a repurchase agreement relating to a previously transferred asset between the same counterparties. The repurchase financing may be agreed upon at the time of the initial transfer or may occur at a later date. The comment period for this project runs through September 14, 2007. The FASB plans to address comments received and issue a final FSP during the fourth quarter of 2007. For more information on this FASB project, please visit the following Web site: www.fasb.org/project/repurchase_financing_agreements.shtml.

.151 The FASB is also working a project that addresses practice issues related to the permitted activities of a QSPE, isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve the comparability of financial statements. The FASB decided that removing the QSPE concept from FASB Statement No. 140 is an approach worthy of research. The FASB recommends that staff consider amending paragraph 9(b) on the remaining criteria in paragraph 9 be included in the research for this project. The FASB expects to issue an exposure draft containing potential amendments to FASB Statement No. 140 in the fourth quarter of 2007. For more information, please visit the following Web site: www.fasb.org/project/transfers_of_financial_assets.shtml.

Clarification of FASB Statement No. 140

.152 On June 15, 2007, members of the U.S. House of Representatives Committee on Financial Services sent a letter to the Chairman of the SEC. The representatives are concerned with current lending practices and the recent collapse of the subprime market. Specifically, the representatives are concerned with the number of foreclosures and the impact of FASB Statement No. 140 on loan modifications. One solution presented by the representatives was to make loan modifications and, where possible, forbear foreclosure.

.153 The representatives asked for SEC expertise on FASB Statement No. 140. They asked if FASB Statement No. 140 clearly addresses whether a loan held in trust can be modified when default is reasonably foreseeable or only once a delinquency or default has already occurred. The representatives believe that the lack of clarity may be leading some institutions to withhold making some loan modifications that may benefit borrowers and bondholders for fear of being in violation FASB Statement No. 140. The SEC is currently looking into this issue. For more information on this issue, readers should refer to the SEC Web site at www.sec.gov.

.154 On July 24, 2007, the SEC responded to the Committee on Financial Services. The letter outlined one approach servicers may take in response to anticipated residential mortgage loan defaults. The approach is to modify the terms of the mortgage loan when default is "reasonably foreseeable," rather than when a default or delinquency has already occurred. The letter also explains that said loan modifications undertaken when loan default is reasonably foreseeable should be consistent with the nature of modification activities that would have been permitted if a default had occurred.

The Hybrid and Servicing Ripple Effect

.155 In addition to the effects on FASB Statement No. 140 discussed in the previous section, the implementation of FASB Statements No. 155 and No. 156 will affect a number of GAAP issues, including but not limited to DIG Issues, EITF Issues, and Technical Bulletins.

FASB Statement No. 158

.156 FASB Statement No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, improves financial reporting by requiring an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This statement also improves financial reporting by requiring an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions.

.157 The required date of adoption of the recognition and disclosure provisions of this statement differs for an employer that is an issuer of publicly traded equity securities (as defined) and an employer that is not. An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006. An employer without publicly traded equity securities is required to recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after June 15, 2007.

Ratification of EITF Issue Nos. 06-4 and 06-5

.158 In September 2006, the FASB ratified EITF Issue Nos. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements" and 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*." EITF Issue No. 06-4 requires that policyholders recognize a liability for the postretirement benefits provided through endorsement split-dollar life insurance. The liability to recognize is dependent upon whether the company is deemed to have promised a death benefit to the participant or to maintain the split-dollar arrangement for the participant's benefit. EITF Issue No. 06-5 provides guidance for calculating policy amounts that could be realized and recognized as assets on the policyholder's balance sheet. Both EITF Issue Nos. 06-4 and 06-5 will be effective for fiscal years beginning after December 15, 2007. The company does not anticipate that these issues will have a material effect on its financial statements.

EITF Issue No. 06-10

.159 The EITF reached consensus that an employer should recognize a liability for post retirement benefits related to a collateral assignment split-dollar life insurance arrangement in accordance with FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, or Option 12 if the employer has agreed to maintain a life insurance policy on the employee during retirement. Examples of evidence to be considered when determining the arrangement include written agreements, communication between the employee and employer, and past practices of the employer. Similarly, if the employer has provided the employee with a death benefit, the employer should accrue a liability for the actuarial present value of the future death benefit as of the employee's expected retirement date, in accordance with FASB Statement No. 106 or Option 12. The consensus for EITF Issue No. 06-10, "Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements," is effective for fiscal years beginning after December 15, 2007, included interim periods within those fiscal years.

Other Literature Important to Financial Institutions

.160 FASB Statement No. 156 also amends paragraphs 9 and 10 of FASB Technical Bulletin No. 87-3, *Accounting for Mortgage Servicing Fees and Rights*; paragraph 8(h) of SOP 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others* (AICPA, *Technical Practice Aids*, ACC sec. 10,850); the FASB Special Report titled *A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—Questions and Answers—Fourth Edition (cumulative); Special Report on Statement 140 on Accounting for Transfers and Servicing* *of Financial Assets and Extinguishments of Liabilities Index of All Q&As Affected by Statement 156 As of March 17, 2006*; and sections of the AICPA Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Intuitions, Credit Unions, Finance Companies, and Mortgage Companies.*

FSP FIN 39-1

.161 FSP FIN 39-1, "Amendment of FASB Interpretation No. 39," issued in April 2007, amended certain aspects of FIN 39, *Offsetting of Amounts Related to Certain Contracts*. The FSP amends paragraph 10 of FIN 39 to permit a reporting entity to offset fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts, including amounts that approximate fair value, recognized for derivative instruments executed with the same counterparty under the same master netting arrangement. This FSP applies to instruments that meet the definition of a derivative in FASB Statement No. 133, including those that are not included in the scope of FASB Statement No. 133 (for example, a financial guarantee or weather derivatives), and indicates that application of the guidance in the FSP is an accounting policy decision and should be consistently applied. Upon adoption of this FSP, a reporting entity is permitted to change its accounting policy to offset or not offset fair value amounts recognized for derivative instruments under master netting arrangements.

.162 The FSP is effective for fiscal years beginning after November 15, 2007, with early application permitted, and is applied as a change in accounting principle through retrospective application for all financial statements presented, unless it is impracticable to do so.

FSP FAS 140-2, Paragraphs 40(b) and 40(c)

.163 Paragraph 35 of FASB Statement No. 140 provides conditions that must be met for a trust or other legal entity to be considered a QSPE. One condition is that a QSPE may hold only passive derivative financial instruments that pertain to beneficial interests issued or sold to parties other than the transferor, its affiliates, or its agents.

.164 Constituents have questioned whether paragraphs 40(b) and 40(c) would require a QSPE to become disqualified if the amount of beneficial interests held by outside parties is reduced to less than the total notional amount of the related derivative financial instruments because of events that were not anticipated at the inception of the QSPE. Constituents have also questioned whether purchases of beneficial interests by the transferor, its affiliates, or its agents in connection with treasury, market-making, or trading activities would disqualify a qualifying QSPE.

.165 FSP FAS 140-2, "Clarification of the Application of Paragraphs 40(b) and 40(c) of FASB Statement No. 140," answers these questions by concluding that paragraph 40(b) and 40(c) requirements must be met when beneficial interests are *initially* issued by the QSPE or when a passive derivative financial instrument needs to be replaced upon the occurrence of a specified event *outside the control* of the transferor, its affiliates, or its agents. For additional specifics, see the FSP available at www.fasb.org, which was effective upon issuance on November 5, 2005.

DIG Issues

.166 FASB Statement No. 155 amends paragraphs 14, 16, 44, and 200A-D of FASB Statement No. 133. Consequently, the following DIG issues are affected: DIG Implementation Issue Nos. A1, B1, B2, B4, B5, B6, B10, B11, B15, B17, B20, B23, B24, B29, B30, B35, B36, B37, B39, C4, and D1. FASB Statement No. 156 amends footnote 9 to paragraph 21 as well as paragraph 56 of FASB Statement No. 133. The statement affects DIG Implementation Issue Nos. B12, B36, D1, F1, F8, and J7.

FASB Implementation Issue No. B-40

.167 In January 2007, the FASB posted Implementation Issue No. B40, "Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets," which clarifies the circumstances in which a securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of FASB Statement No. 133. They responded that a securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of FASB Statement No. 133 if it meets both of the following criteria:

- The right to accelerate the settlement of the securitized interest cannot be controlled by the investor.
- The securitized interest itself does not contain an embedded derivative (including an interest-rate-related derivative) for which bifurcation would be required other than an embedded derivative that results solely from the embedded call options in the underlying financial assets.

.168 The objective of this guidance is to provide a narrow scope exception from paragraph 13(b) of FASB Statement No. 133 for securitized interests that contain only an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets and that meet the criteria listed in the previous paragraph. For more information, please visit the following Web site: www.fasb.org/derivatives/issueb40.

EITF Issues

.169 FASB Statement No. 155 affects EITF Issue Nos. 85-9, 85-29, 86-15, 86-28, 90-19 , 96-12, 97-15 98-5, 99-20, 00-19, 03-7, instrument C of Issue No. 90-19, and 88-11. FASB Statement No. 156 affects EITF Issues No. 85-13, 87-34, 88-11 (nullified), 88-22, 89-2, 90-18, 90-21, 90-2, 02-9, 02-12, and Topic D-69.

Hybrid Financial Instruments

.170 FASB Statement No. 133 requires transactions to be evaluated for embedded derivatives. If the derivative is present, it has to be bifurcated if the following three criteria are met: (1) the economics of the derivative are not clearly and closely related to the economics of the host instrument, (2) the instrument is not measured at fair value through earnings, and (3) the terms of the derivative meet the definition of a derivative under FASB Statement No. 133. The host is accounted for based on applicable literature (for example, cost amortization) while the derivative is accounted for at fair value through earnings unless it is designated as a FASB Statement No. 133 hedge.

.171 If an embedded derivative is present but not closely and clearly related to its host instrument, the entity must apply FASB Statement No. 155. The statement allows the entity a choice in accounting for embedded derivates requiring bifurcation. An entity can elect to either bifurcate the embedded derivative or carry the entire instrument at fair value with changes that pass through the income statement. Thus far, holders of embedded derivatives have been disappointed in the choices.

.172 FASB Statement No. 155 is effective for all financial instruments acquired or issued after the beginning of the fiscal year that begins after September 15, 2006. Auditors should be aware that FASB Statement No. 155 applies to securities purchased after adoption or securities that have a remeasurement event, for example, a business combination. Only securities purchased after adoption are evaluated to determine if there is an embedded derivative and whether or not that derivative should be bifurcated from its host.

FASB Statement No. 156

.173 FASB Statement No. 156 amends FASB Statement No. 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. The statement requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract under certain circumstances.

.174 FASB Statement No. 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. It permits an entity to choose either of the amortization or fair value methods for each class of separately recognized servicing assets and servicing liabilities.

.175 At its initial adoption, it permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized SRs, without calling into question the treatment of other available-for-sale securities under FASB Statement No. 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value.

.176 The statement also requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities.

.177 An entity should adopt this statement as of the beginning of its first fiscal year that begins after September 15, 2006. For more information, please visit the FASB Web site at www.fasb.org.

Recent Auditing and Attestation Pronouncements and Related Guidance

.178 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.179 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for periods beginning on or after December 15, 2006.

SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A), to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120) • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325A). It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	See the "AICPA Risk Assessment Standards" section in this alert.
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.

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Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325.01–.04), which interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.
Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330.01–.06), which interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.
TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This PA responds to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.
AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This PA provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditor's report.
PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This standard replaces the PCAOB's previous internal control standard, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.
PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This rule requires a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the SEC or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm's independence, and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee pre-approval to perform tax services for an audit client under PCAOB Rule 3524. This rule is effective for audits of fiscal years ending on or after November 15, 2007.

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PCAOB Conforming Amendments to the Interim Auditing Standards Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in Appendix 3 of PCAOB Release No. 2007-005A at www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.
PCAOB Report, *Report on the Second-Year Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report is based on PCAOB inspections that looked at parts of approximately 275 audits of internal control over financial reporting by registered public accounting firms. Inspections focused on four areas: integrating the audits of financial statements and internal control, using a top-down approach, using the work of others, and assessing risk.
PCAOB Report, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 300—Report on the Initial Implementation of Auditing Standard No. 2") Issue Date: January 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report focuses on aspects of the PCAOB's interim auditing standards that address the auditor's responsibility with respect to fraud, specifically AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.
PCAOB Staff Questions and Answers , *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	Topics covered include the following: • The application of Rule 3522(a) when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm • Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction • Whether a registered public accounting firm's independence is affected by the IRS's subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b) • Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself • Clarification of the term *other change in employment event* as it relates to Rule 3522(c)

PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 100—PCAOB Staff Questions and Answers") Issue Date: October 2006 (Applicable to audits conducted in accordance with PCAOB standards)	The guidance provides direction for auditing a company's estimation of the fair value of stock options granted to employees pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment*, which became applicable for financial statements of companies with fiscal years ending on or after June 15, 2006.

The Auditor's Communication With Those Charged With Governance

.180 In December 2006, the ASB issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and is effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to 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. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.181 SAS No. 114 recognizes the importance of effective two-way communication to the audit. It provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires significant matters communicated with those charged with governance to be documented.

Identifying Those Charged With Governance

.182 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those 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.

.183 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.184 Since there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.185 In May 2006, the AICPA ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. However, with the adoption of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* the PCAOB redefined these terms, which now differ from SAS No. 112.

- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.

- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, as well as indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.

- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.

- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.

- Contains illustrative written communications to management and those charged with governance.

How Revisions of SAS No. 112 Affect Practice

.186 As auditors gain a better understanding of what needs to be communicated to management and those charged with governance, there may be more control deficiencies that are identified as significant deficiencies and material weaknesses, and communicated to management and those charged with governance. Auditors may emphasize and therefore spend more time evaluating identified control deficiencies than in the past.

Discussions With Management and Others

.187 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. Auditors may have to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor who does not provide attest services for the client can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.188 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of material weaknesses. Another reason is that auditors have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in written communication as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.189 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present, because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented, detected, and corrected by the client.

Issues for Audits of Smaller Entities

.190 One issue that may arise in audits of smaller entities is the possibility of increased costs as a result of the auditor time spent documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.191 Another issue that may cause concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, detecting, or correcting material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, since doing so would impair independence.[3] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

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[3] See Ethics Ruling 101-3, "Performance of nonattest services," of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

.192 The new requirements of SAS No. 112 introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing.

.193 The AICPA has published the AICPA Audit Risk Alert titled *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in implementation of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

AICPA Risk Assessment Standards

.194 In March 2006, the AICPA ASB issued eight SASs referred to as the risk assessment standards (SAS Nos. 104–111). Although the SASs include many of the underlying concepts and detailed performance requirements contained in existing standards, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risk of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between the risks, controls, audit procedures, and conclusions. The risk assessment standards are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier applications permitted. The following table lists the eight SASs and their effects on existing standards.

Statement on Auditing Standards	*Effect on Existing Standards*
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")* (AICPA, *Professional Standards*, vol. 1, AU sec. 230)	This statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230A).
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	This statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A).
SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)	This statement supersedes SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326A).
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)	This statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312A).
SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)	This statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 310), and supersedes SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A).

SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314)	This statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1, AU sec. 318)	This statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)	This statement amends SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350A).

Key Provisions of the Risk Assessment Standards

.195 Whether due to error or fraud, the new risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks to the client's business and the mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations of the Treadway Commission's (COSO) framework, www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs will most likely result in significant changes to firm audit methodologies and the training of personnel. Therefore, it is recommended that auditors allow ample time in advance of the required implementation date. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Companion Audit Guide

.196 In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Audit Documentation Technical Practice Aids

.197 In May 2007, the ASB issued two Technical Practice Aid (TPA) Technical Questions and Answers (TIS) related to SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which was issued in December 2005.

.198 TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because, since management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.199 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) discusses whether the provisions of SAS No. 103 related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance*

.200 A key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.201 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date
- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.202 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf. Readers should also note the PITF is currently working on a practice alert that addresses auditing and other considerations related to electronic information which it plans to issue during the third quarter of 2007.

PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*

.203 In May 2007, the PCAOB adopted Auditing Standard No. 5, which was later approved by the SEC on July 25, 2007. This standard replaces Auditing Standard No. 2. Auditing Standard No. 5 is principles-based and presents a risk-based, top-down approach designed to increase the likelihood that material weaknesses will be found before resulting in a material misstatement of a company's financial statements, while eliminating unnecessary procedures. The standard was also designed to make audits more scaleable for smaller or less complex companies. The PCAOB worked closely with the SEC to coordinate Auditing Standard No. 5 with the guidance to public company management that was approved by the SEC in May 2007. Mark Olson, PCAOB Chairman, stated "The new standard is more risk based and scalable, which will better meet the needs of investors, public companies, and auditors alike."

.204 This new standard is required for all audits of internal control for fiscal years ending on or after November 15, 2007. However, early adoption is permitted and encouraged. For more information, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk).

Recent AICPA Independence and Ethics Pronouncements

.205 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.206 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions (FSPs) (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA Statement of Position (SOP) 07-1 (AICPA, *Technical Practice Aids*, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*
TIS section 6140.20–.22 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss not-for-profit organizations fund-raising expenses.

(continued)

TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various employee benefit plan topics.
TIS section 6300.25–.35 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various issues related to SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.207 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the financial institutions industry are discussed throughout this alert. The AICPA general *Audit Risk Alert—2007/08* and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or go online at www.cpa2biz.com.

On the Horizon

.208 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to the financial institutions industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.209 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. 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 in addition to those discussed here. 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/Professional+Resources/Accounting + and+Auditing/Audit+and+Attest+Standards/ Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting + and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional + Ethics+Code+of+Professional+Conduct/ Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Auditing Pipeline—Nonissuers

ASB Clarity Project

.210 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB approved for exposure a discussion paper titled *Improving the Clarity of ASB Standards*. This discussion paper seeks feedback on proposed changes to the standards, including:

- Establishing objectives for each of the standards, and the auditor's obligations related to the objectives.
- Structural and drafting improvements to make the standards easier to read and understand.
- Inclusion, in the explanatory material of the standards, special considerations related to audits of public entities and small entities.
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards.

.211 The period to comment ended June 15, 2007. The discussion paper can be accessed at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

Convergence With International Standards

.212 The ASB has created a number of task forces charged with monitoring specific activities of the International Auditing and Assurance Standards Board (IAASB) and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of International Standards on Auditing (ISA). The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.213 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, the ASB previously decided to defer to issuance of a final revised AT section 501 until the PCAOB issued its amendments and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www.aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*

.214 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled Amendment to Statement on Auditing Standards No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards titled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA, *Professional Standards*, vol. 1, AU sec. 411]) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www.fasb.org. The ASB will issue its final SAS coincidentally with the FASB's and PCAOB's issuance of their final standards.

Auditing Pipeline—Issuers

.215 Guidance issued by the PCAOB is included in the section of this alert titled "Recent Auditing and Attestation Pronouncements and Related Guidance." For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), mentioned previously.

Accounting Pipeline

.216 Presented below are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year alert have not been finalized as of the date of this writing, and thus are included again.

Business Combinations

.217 Phase one of the business combination project resulted in the issuance of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*. In those statements, the FASB eliminated the use of the pooling of interests method of accounting for business combinations and addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. The objective of phase two of this project is to standardize business combination accounting through the convergence of the FASB and International Accounting Standards Board (IASB) accounting standards and by reconsidering the existing guidance for the purchase method of accounting for business combinations. Among the main proposals are the following:

- All acquisitions of businesses be measured at the fair value of the business acquired.
- Substantially all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.
- Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.218 In June 2005, the FASB and IASB (the Boards) issued a number of exposure drafts, for which comment periods ended in October 2005. Redeliberations began in January 2006 and were completed in June 2007. The Boards expect to issue final statements during the fourth quarter of 2007. Four standards are expected to be issued:

- Proposed FASB Statement No. 141(R) and International Financial Reporting Standard (IFRS) No. 3(R), *Business Combinations*

- Proposed FASB Statement No. 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*
- Proposed International Accounting Standard (IAS) Statement No. 27(R)

.219 Readers should remain alert to the final issuances and visit the FASB Web site for further information.

Fair Value

.220 During phase one of the FASB's fair value option project, the FASB issued FASB Statement No. 159, which was previously discussed. In phase two of the project, the FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase two are expected to begin in the third quarter of 2007. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.221 In December 2006, the FASB issued an exposure draft titled *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure ended in March 2007 and the FASB has begun redeliberations to consider significant issues raised by respondents. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133 including how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entity's financial position, results of operations, and cash flows. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.222 The FASB is working on a project to amend FASB Statement No. 140 to address issues related to the permitted activities of a QSPE, isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, the FASB issued exposure draft, *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During 2007, the FASB expects to address issues related to the permitted activities of a QSPE and then issue another exposure draft during the fourth quarter of 2007 containing potential amendments to FASB Statement No. 140. See the FASB Web site for complete information.

Earnings Per Share

.223 The FASB and IASB have been working together to resolve differences between FASB Statement No. 128, *Earnings per Share*, and IAS Statement No. 33, *Earnings per Share*. This project is part of the larger FASB project, Short-term International Convergence, which has resulted in the issuance of a number of FASB Statements. Currently the FASB and IASB are addressing significant differences that remain relating to instruments that can be settled in cash or shares and are classified as a liability on an entity's balance sheet. The FASB and IASB are considering modifications to the treasury stock method and several scoping issues in which either the FASB or IASB has issued or may issue more detailed implementation guidance on earnings per share that may create a convergence difference. The FASB and IASB are expected to issue an exposure draft for public comment during the third quarter of 2007. This exposure draft will be the third exposure draft the FASB has issued on the earnings per share project. The project and current exposure draft can be reviewed on the FASB Web site.

FASB Codification and Retrieval Project

.224 The goal of this FASB project is to create a single, authoritative codification of U.S. GAAP. The codification will integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, EITF, and the SEC). The codification will have a three layered structure: topic, subtopic, and section. The FASB has structured the topics into three primary areas: overall presentation, transactional (or financial statement account), and industry. The overall presentation area addresses presentation of financial information, but does not address items such as recognition, measurement, or derecognition. The transactional or financial statement account area addresses accounting recognition, measurement, or derecognition. The industry area includes guidance unique to the industry. A codification draft is expected in 2007 and will have an extended verification period to ensure that it accurately reflects U.S. GAAP. Once the FASB addresses respondent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards. Readers can track progress of the Codification and Retrieval Project on the FASB Web site at www.fasb.org/project/codification&retrieval_project.shtml.

GAAP Hierarchy

.225 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA AU section 411. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, who is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in AU section 411, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonissuers" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.226 ***Proposed FASB EITF Issues***. Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.227 ***Proposed FSPs***. A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

.228 The following are various resources that practitioners engaged in the depository and lending institutions industry may find beneficial.

Publications

.229 Practitioners may find the following publications useful with respect to the depository and lending industry:

- Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* (2007) (product no. 012737kk)
- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)

- Audit Guide *Auditing Derivative Instruments Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2007) (product no. 012517kk)
- Audit Guide *Audit Sampling* (2007) (product no. 012537kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2007) (product no. 012777kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- Audit Risk Alert *Compilation and Review—2007/08* (product no. 022308kk)
- Audit Risk Alert *Independence and Ethics—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Checklist and Illustrative Financial Statements for Depository and Lending Institutions* (product no. 008916kk)
- Audit and Accounting Practice Aid *Illustrative Disclosures on Derivative Loan Commitments* (product no. 006642kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.230 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. 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.

Continuing Professional Education

.231 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191 [DVD]). 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.
- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

Among the many courses, *Audits of Banks and Other Financial Institutions* (self study) (product no. 733440) specifically relates to the banking and lending institutions industry. Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.232 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics.

.233 To register or learn more, visit www.cpa2biz.com.

Webcasts

.234 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.235 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.236 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.237 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.238 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. You can reach the Technical Hotline at (888) 777-7077.

Ethics Hotline

.239 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.

Industry Conference

.240 The AICPA sponsors an annual conference on banks and savings institutions in the winter. The National Conference on Banks & Savings Institutions is a three-day conference designed to update attendees on recent developments related to all banking operations. This is the only conference where both community banks and large banking institutions can acquire the critical understanding of current banking issues on emerging audit, accounting, and regulatory developments. Speakers will focus on issues and updates as well as forecasts and trends in the banking industry. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA CAQ

.241 The CAQ (formerly the Center for Public Company Audit Firms) was created to serve investors, public company auditors and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.242 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

AICPA Industry Expert Panel—Depository Institutions

.243 For information about the activities of the Depository Institution Industry Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_depository.htm.

Industry Web Sites

.244 The Internet covers a vast amount of information that may be valuable to auditors of financial institutions, including current industry trends and developments. Some of the more relevant sites for auditors with financial institution clients include those shown in the following table.

Organization	*Web Site*
Federal Deposit Insurance Corporation	www.fdic.gov
Financial Crimes Enforcement Network	www.fincen.gov
Mortgage Bankers Association	www.mbaa.org
National Credit Union Administration	www.ncua.gov
Office of the Comptroller of the Currency	www.occ.treas.gov

.245 The financial institution practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

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.246 This Audit Risk Alert replaces *Bank, Credit Union, and Other Depository and Lending Institution Industry Developments—2006/07*.

.247 The Audit Risk Alert *Bank, Credit Union, and Other Depository and Lending Institution Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to kbiser@aicpa.org or write to:

Kenneth R. Biser, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

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Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, Practice Bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+ and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+ and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org

(continued)

Web Site Name	*Content*	*Web Site*
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov

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AAM Section 8060

Employee Benefit Plans Industry Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

Linda C. Delahanty, CPA
Technical Manager
Audit and Attest Standards

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your employee benefit plan audits. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory 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 financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 Employee benefit plans may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the plan's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the plan's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the plan's business is also dynamic, and the plan's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the plan and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

.09 Paragraphs 5.56–.59 in the AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2008, provide additional guidance on understanding the plan and its environment.

Hot Topics

The Subprime Mortgage Crisis and Other Market Events

.10 The repercussions of subprime mortgage events continue to be felt in the financial markets. Liquidity in the market for subprime-mortgage-backed securities has deteriorated significantly since the major rating agencies began to downgrade subprime mortgage ratings on a number of issues, including the increased numbers of delinquencies and foreclosures. Additionally, a number of highly leveraged hedge funds (and other investment vehicles) breached various borrowing and margin covenants, which resulted in portfolio liquidations both of subprime-asset-backed securities and, at times, other unrelated investments. Price quotations for subprime-asset-backed securities have become increasingly difficult to obtain and, when obtained, exhibit wide, bid-asked spreads. The auctions for the auction market preferred stock for many entities, including closed-end funds, have failed early in 2008. Further, actual transactions periodically occur at values significantly different from quoted prices, due both to the general market illiquidity and the presence of distressed sellers.

.11 One major spillover effect of these events has been in the market for short term commercial paper, particularly securities backed by various financial assets. Some of this paper, issued by structured investment vehicles, other conduit structures, and hedge funds, was supported in part by subprime mortgage securities. The paper was rated investment grade because the value of the collateralizing securities was significantly higher than the outstanding debt. In some cases, the deterioration in the subprime market caused this overcollateralization to be reduced below the levels permitted under the commercial paper issuance program, resulting in the unexpected extension of maturities or the repayment of maturing paper through drawdowns on bank lines of credit because the issuers could not sell new paper on the market. The resulting uncertainty about these issuers' outstanding commercial paper, and the potential for other issuers to encounter the same difficulties, caused the market for asset-backed commercial paper to exhibit many of the same signs of illiquidity apparent in the subprime market. In some cases, issuers who had not breached covenants but were perceived as having some of the same risk characteristics of troubled issuers had difficulty selling commercial paper.

.12 Various money market funds (both registered and unregistered) have acknowledged investments in troubled paper. They have enhanced their procedures to monitor the differences between net asset value as determined using amortized cost and market values of securities, as required by Rule 2a-7 under the Investment Company Act of 1940 or other equivalent regulations. Some money market funds may have material differences between amortized cost and the market value of securities, resulting in a share value reported in the audited financial statements that is different than what is used for participant transactions and reported on the trustee or custodial statements at year-end.

.13 It is important for the auditor to be aware of the increased risk posed by current market conditions and to develop or modify audit procedures accordingly. Among other things, auditors may consider the following:

- The overall effect of risk on a plan's portfolio of subprime mortgages and related investments (for example, asset-backed commercial paper or high-yield debt or loans). The auditor should identify risks throughout the process of obtaining an understanding of the plan and its environment, including relevant controls such as controls at the plan sponsor and outside service provider, including any applicable investment service provider. The auditor may also consider the policies that affect the management and monitoring of these investments.
- The increased difficulty of obtaining reliable valuations for certain types of asset-backed securities, given the decrease in market liquidity. The auditor should obtain an understanding of the plan's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach. This would include controls over valuation at the plan sponsor and service provider, in particular the extent to which they monitor valuations obtained from brokers and external pricing services for consistency with observations of market conditions, as well as the involvement of valuation committees or other internal review groups independent of portfolio managers in assessing the day-to-day reasonableness of security valuations and overriding quotations that appear to be unrepresentative.
- The existence of financial covenants within the vehicle and its compliance with those covenants to the extent an investment vehicle has employed leverage. The auditor may obtain an understanding of management's ongoing monitoring process. If the vehicle is no longer in compliance with the

covenants, the auditor would assess the appropriate accounting and reporting implications, including AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1).

.14 In certain instances, the auditor may need special skills or knowledge to plan and perform auditing procedures for plans that hold subprime-mortgage-backed securities. AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), states that for some derivatives and securities, generally accepted accounting principles (GAAP) may prescribe presentation and disclosure requirements. Furthermore, AU section 332 advises the auditor to consider the form, arrangement, and content of the financial statements (including the notes) when evaluating the adequacy of presentation and disclosure. Auditors may also consider using a specialist when determining how to audit a plan that deals in derivatives. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance on the use of a specialist during an engagement.

Impact on Employee Benefit Plans

.15 As a result of the conditions in the subprime markets, several business and accounting issues arise, many of which relate to the measurement of the fair value of securities in the current illiquid market and the devaluation of commercial paper or other securities in money market funds or held as collateral for security lending transactions. Although the plan sponsor is responsible for establishing an accounting and financial reporting process for determining fair value measurements, the plan sponsor will typically rely on the trustee or custodian for the pricing of its investments. The trustee or custodian may use an outside service provider or pricing service for valuation of the investments. Although the valuation function may be outsourced in whole or in part, management continues to maintain ultimate responsibility.

.16 Pricing services typically used by plan trustees or custodians to provide investment prices, such as Interactive Data Pricing and Reference Data, have issued press releases to inform users that they are experiencing difficulties in obtaining consistent market information in the production of valuations of subprime-related securities. Therefore, certain service providers have enhanced their procedures to respond to these issues including, among other things, more frequent monitoring of the differences between amortized cost and the market value of securities for money market funds and close monitoring of the portfolios for exposure to these markets and the associated valuations of these securities.

.17 Accordingly, for full scope audits, auditors may consider the procedures and controls put in place by the plan sponsor and service provider to identify problem investments and pricing concerns; validate the reliability of pricing or institute fair-value procedures, or both, if necessary; monitor the collectibility of accrued income; and modify reporting and disclosures based on the exposure of these markets in their plans. Auditors may also consider the need to enhance audit procedures to ensure that prices obtained from pricing services are reasonable, including the use of multiple pricing sources or valuation experts to review any pricing models or fair value methodologies put in place, or both. Prices used to value money market type funds in trustee or custodial statements may be compared to published prices or agreed to audited financial statements of the funds.

.18 Events or transactions sometimes occur that affect the measurement of fair value of financial instruments, subsequent to the balance-sheet date but prior to the issuance of the financial statements, that have a material effect on the financial statements and therefore require adjustment or disclosure in the statements. The determination of whether such information represents a type 1 or type 2 subsequent event is highly judgmental and will be based on the specific facts and circumstances. For example, the subsequent events procedure to review trustee or custodial statements after year-end may identify pricing adjustments to investment accounts. Auditors may consider if the adjustment resulted from specific market events occurring (1) after year-end (type 2 event) or (2) as of year-end (type 1). Type 1 subsequent events may need to be recorded as an adjustment to the year-end financial statements. See AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), for further guidance. Flexibility in auditing procedures will help the auditor to respond to changes in market conditions.

.19 For limited scope audits, if the auditor becomes aware that the certified information relating to such investments is inaccurate as a result of valuation or other concerns, further inquiry may be necessary that might result in additional testing or modification to the auditor's report. See the "Limited Scope Certifications" section of this alert for further guidance.

.20 In addition, auditors should consider the requirements of Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids*, ACC sec. 10,640), regarding disclosing significant risks and uncertainties in the plan's financial statements at year-end regarding investments affected by subprime, illiquid, or other market events. The following is an example of such a disclosure.

.21 The plan invests in securities with contractual cash flows, such as asset backed securities, collateralized mortgage obligations and commercial mortgage backed securities, including securities backed by subprime mortgage loans. The value, liquidity and related income of these securities are sensitive to changes in economic conditions, including real estate value, delinquencies or defaults, or both, and may be adversely affected by shifts in the market's perception of the issuers and changes in interest rates.

> **Help Desk—**For audits of issuers, such as Form 11-K audits, the guidance in Public Company Accounting Oversight Board (PCAOB) Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, would be applicable.

Additional Guidance

.22 The following is a list of additional resources that provides guidance on auditing investments:

- AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards,* vol. 1)
- AU section 332, *Auditing Derivative Instruments, Hedging Activities and Investments in Securities*
- AU section 336, *Using the Work of Specialists*
- AU section 342, *Auditing Accounting Estimates*
- AU section 560, *Subsequent Events*
- PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*
- Center for Audit Quality (CAQ) white paper *Measurement of Fair Value in Illiquid (or Less Liquid) Markets*
- AICPA Practice Aid *Alternative Investments—Audit Considerations*

New Filing and Audit Requirements for ERISA-Covered 403(b) Employee Benefit Plans

.23 Section 403(b) plans are also commonly known as *tax-sheltered annuity plans* (TSA plans). A 403(b) TSA plan is a retirement plan offered by schools, hospitals, churches, charities, and certain other tax-exempt organizations. An individual's 403(b) annuity can be obtained only under an employer's TSA plan. Generally, these annuities are funded by elective deferrals made under salary reduction agreements and may include nonelective employer contributions. A 403(b) plan works very similarly to a 401(k) plan.

.24 A 403(b) plan comprises individual investment accounts that include the following types:

- Fixed and variable annuity contracts with insurance companies, [403(b)(1) annuities]
- Custodial accounts made up of mutual funds [403(b)(7) accounts]
- A retirement income account set up for church employees [403(b)(9) accounts]

Revisions to the Form 5500 for 403(b) Plans

.25 On November 16, 2007, the Employee Benefits Security Administration (EBSA), the IRS, and the Pension Benefit Guaranty Corporation (PBGC) published in the Federal Register revisions to the Form 5500 annual return/report for plan year 2009. The revisions include improved financial disclosure by the approximately 16,000 403(b) TSA plans subject to Title I of Employee Retirement Income Security Act (ERISA) by making the reporting rules for those 403(b) plans on par with 401(k) plans.

.26 This means that beginning in 2009, employee benefit plans sponsored by charitable organizations and schools under Internal Revenue Code (IRC) section 403(b) and covered under ERISA will be subject to the same reporting and audit requirements that currently exist for section 401(k) plans. This will involve the completion of the Form 5500 as a small or large pension plan, depending on the number of participants eligible to participate in the plan as of the beginning of the plan year. The Department of Labor (DOL) anticipates that most small 403(b) plans will be eligible to use the new Form 5500-SF and thus will only have to meet that limited filing obligation.

.27 For large 403(b) plans, however, the new reporting requirements will require not only the completion of the entire Form 5500, but also the engagement of an independent qualified public accountant (IQPA) to conduct an independent audit of the plan.

.28 The DOL intends to fully enforce this new audit requirement in 2009. Accordingly, it is critical that plan auditors educate themselves and their clients about this change and its effects on plan records that will be subject to audit. Under the current reporting model, it is not uncommon for 403(b) plans to have participant records that are difficult to "roll up" into plan-level records. Careful consideration of such situations will be essential in 2008 to ensure that these 403(b) plans will be auditable in 2009.

.29 The 2009 Form 5500 package and the related Federal Register notices are available on the EBSA's Web site at www.dol.gov/ebsa.

First Year Auditing Considerations for 403(b) Plans

.30 If the auditor did not audit the plan's financial statements or they have not been previously audited, the auditor should apply procedures that are practicable and reasonable in the circumstances to assure him- or herself that the accounting principles used by the plan in the current and the preceding year are consistent. See paragraphs .24–.25 of AU section 420, *Consistency of Application of Generally Accepted Accounting Principles*, for further guidance.

.31 Areas of special consideration in an initial audit of a plan's financial statements include (*a*) the completeness of participant data and records of the prior year(s), especially as they relate to participant eligibility; (*b*) the amounts and types of benefits; (*c*) the eligibility for benefits; and (*d*) account balances. The nature, timing, and extent of auditing procedures applied by the auditor are a matter of judgment and will vary with factors such as the adequacy of past records, the significance of beginning balances, and the complexity of the plan's operations. Because ERISA requires that audited plan financial statements present comparative statements of net assets available for benefits, the current year statements should be audited, and the prior year that is presented for comparative purposes may be either compiled, reviewed, or audited.

Appropriate reference in the current year audit report should be made to describe the level of responsibility assumed in the prior year. However, although a compilation or review of prior year is acceptable, the auditor would apply sufficient auditing procedures on the beginning balance of net assets available for benefits to obtain appropriate evidence that there are no material misstatements to these beginning balances that may affect the current year's statement of changes in net assets available for benefits.

Automatic Enrollment and Planning Considerations

.32 There has been a significant increase in the number of plan sponsors choosing to automatically enroll plan participants largely because the Pension Protection Act of 2006 (PPA) included provisions designed to encourage sponsors of 401(k) plans to add an automatic enrollment feature.

.33 Automatic enrollment is a mechanism under which an eligible employee who does not make an affirmative election to make pretax contributions to the plan is automatically enrolled in the plan at a specific pretax contribution percentage, unless the employee specifically opts out. Because those funds must then be invested, the PPA also included provisions to protect plan fiduciaries that invest a participant's account in certain default investment options. Recently, the IRS issued proposed regulations regarding the implementation of automatic contribution arrangements, and the DOL issued final regulations regarding default investments.

.34 On October 24, 2007, the DOL published a final rule in the Federal Register establishing qualified default investment alternatives (QDIA), making it easier for employers to automatically enroll workers in their 401(k) and other defined contribution (DC) plans. Auditors may want to consider any amendments made to the plan document as a result of the PPA provisions when determining the scope of the audit.

.35 The IRS issued proposed regulations in November of 2007 to implement automatic enrollment. The proposed regulations describe 2 types of automatic enrollment arrangements: an eligible automatic contribution arrangement and a more complex qualified automatic contribution arrangement that passes certain nondiscrimination rules automatically.

.36 The final regulation does not identify specific investment products. Rather, it describes mechanisms for investing participant contributions. The intent is to ensure that an investment qualifying as a QDIA is appropriate as a single investment capable of meeting a worker's long term retirement savings needs.

.37 A copy of the regulation and a fact sheet detailing the rule may be found at the DOL's Web site at www.dol.gov/ebsa/regs.

AICPA Risk Assessment Standards

.38 The eight SASs referred to as "the risk assessment standards" (SAS Nos. 104–111) became effective for audits of financial statements for periods beginning on or after December 15, 2006, (earlier application was permitted), which means they are effective for 2007 calendar year audits. Although the SASs include many of the underlying concepts and detailed performance requirements contained in the standards they amend or supersede, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risks of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage among the risks, controls, audit procedures, and conclusions. Chapter 5 of Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2008, discusses how the risk assessment concepts may be applied in employee benefit plan audits. Auditors are encouraged to review such guidance.

Key Provisions of the Risk Assessment Standards

.39 Whether due to error or fraud, the risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks that may lead to a material misstatement in the plan's financial statements and any mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. It is not acceptable to simply deem risk to be "at a maximum." Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations of the Treadway Commission's framework at www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs should have already been completed and has likely resulted in significant changes to firm audit methodologies and personnel training.

.40 The AICPA issued Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk), which can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Companion Audit Guide

.41 In December 2006, the AICPA published Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This authoritative guide helps auditors further understand the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Technical Questions and Answers

.42 The following Technical Questions and Answers have been developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111, the risk assessment standards.

- TIS section 8200.05, "Testing the Operating Effectiveness of Internal Control"
- TIS section 8200.06, "The Meaning of Expectation of the Operating Effectiveness of Controls"
- TIS section 8200.07, "Considering a Substantive Audit Strategy"
- TIS section 8200.08, "Obtaining an Understanding of the Control Environment"
- TIS section 8200.09, "Assessing Inherent Risk"

These questions and answers are available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/Recently+Issued+Technical+Practice+Aids.htm.

Limited Scope Certifications

.43 When a plan administrator elects to have a limited scope audit performed, the auditor is instructed by the plan administrator to limit the scope of testing on investment information prepared and certified by a qualified trustee or custodian as complete and accurate. Typically, the trustee or custodian certifies to the completeness and accuracy of the plan's investment assets and investment activity as contained in his or her ordinary books and records, which may or may not be fair value (for example, it may not be based on market quotations or year-end valuations). Although the DOL regulations allow the qualified trustee or custodian to report in this manner, it is the plan sponsor's responsibility to prepare the financial statements and footnote disclosures in accordance with GAAP (that is, at fair value as of the plan year-end).

.44 The auditor's responsibilities for investments covered by the limited scope exemption are to (1) obtain and read a copy of the certification from the plan administrator, (2) determine whether the entity issuing the certification is a qualifying institution under DOL regulations, (3) compare the certified investment information to the financial information in the financial statements and related disclosures, (4) perform the necessary procedures to become satisfied that any received or disbursed amounts reported by the trustee or custodian were determined in accordance with the plan provisions, and (5) determine whether the form and content of the financial statement disclosures related to the investment information prepared and certified by the plan's trustee or custodian are in conformity with GAAP and are in compliance with DOL rules and regulations.

.45 The scope limitation and the corresponding limitation of the auditor's work extend only to investments and related investment information certified by the qualified trustee or custodian. Plan investments not held by a qualified trustee or custodian, such as real estate, leases, mortgages, self-directed brokerage accounts, participant loans, and any other investments or assets not covered by such an entity's certification, should be subjected to appropriate audit procedures. Moreover, the appropriate audit procedures for all noninvestment related information (for example, benefit payments, employer and employee contributions, and receivables) are the same for a limited scope audit as they are for a full scope audit.

.46 When engaged to perform a limited scope audit, the auditor has no responsibility to perform audit procedures on investments and related activity covered by the certification. Although the auditor is not required to audit certain investment information when the limited scope audit exception is applicable, if the auditor becomes aware that the certified information is incomplete, inaccurate, or otherwise unsatisfactory, further inquiry may be necessary that might result in additional testing or modification to the auditor's report. In certain instances, a limited scope audit may no longer be appropriate (or may only be appropriate with respect to certain investments held by the plan).

.47 Because plans increasingly invest in alternative investments (including hedge funds, real estate, limited partnerships, private equity funds, and other difficult-to-value investments), care ordinarily should be taken by plan administrators when determining if certified information can be relied upon in preparing the plan's Form 5500 and related financial statements. If, for example, the auditor becomes aware that adequate year-end valuation procedures have not been performed and therefore the financial statements may not be prepared in conformity with GAAP, the auditor would communicate those findings to the plan administrator. It is the plan administrator's responsibility to prepare the financial statements and footnote disclosures in conformity with GAAP and in compliance with DOL rules and regulations. Accordingly, the plan administrator may request the trustee or custodian to recertify or amend the certification for such investments at their appropriate year-end values or to exclude such investments from the certification. If the trustee or custodian amends the certification to exclude such investments from the certification, or if the trustee or custodian does not recertify those investments, the plan administrator is responsible for valuing such investments as of the plan year-end and engaging the auditor to perform full audit procedures on the investments excluded from the certification. Paragraph 7.69 of Audit and Accounting Guide *Employee Benefits Plans*, with conforming changes as of March 1, 2008 contains an illustrative auditor's report when plan investments have been certified and the plan administrator was unable to determine whether the investment information is valued in conformity with GAAP.

.48 Prior to being engaged to perform a limited scope audit, it is recommended that plan administrators and their auditors briefly discuss the nature of the investments held by the plan (including how those investments are valued) to help ensure that the plan administrator engages the auditor to perform the appropriate type of audit. The plan administrator's decision regarding whether it can rely on a certification for purposes of limiting the scope of the audit has become increasingly more challenging (especially in light of the investment-related issues previously discussed in this alert).

Fair Value Measurements

.49 In September 2006, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 157, *Fair Value Measurements*, to provide enhanced guidance for using fair value to measure assets and liabilities.

This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. FASB Statement No. 157 amends paragraph 11 of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, to change the definition of *fair value*.

.50 Prior to FASB Statement No. 157, certain fair value measurements were based on the price that would be paid to acquire an asset (an entry price). FASB Statement No. 157 clarifies the definition of *fair value* as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date (an exit price). The exit price is based on the amount that the holder of the asset or liability would receive or need to pay in an actual transaction (or in a hypothetical transaction if an actual transaction does not exist) at the measurement date. In some circumstances, the entry and exit price may be the same; however, they are conceptually different.

.51 Fair value is generally determined based on quoted market prices in active markets for identical assets and liabilities. If quoted market prices are not available, the company uses valuation techniques that place greater reliance on observable inputs (assumptions based on market data) and less reliance on unobservable inputs. In measuring fair value, the plan may make adjustments for risks and uncertainties if a market participant would include such an adjustment in its pricing. Fair value measurements for each major asset or liability are required to be disclosed under FASB Statement No. 157, categorized by where the measurement falls in the fair value hierarchy as discussed in paragraphs 22–31 of the standard.

Effect on Employee Benefit Plans

.52 FASB Statement No. 157 may have a significant effect on the financial reporting for employee benefit plans depending upon the types of investments held by the plan, such as investments in stocks, employer securities, corporate bonds, government securities, investment and insurance contracts, and hard-to-value alternative investments. These investments are made directly by the plan or through common/collective trusts (CCTs), pooled separate accounts, master trusts, investment entities, and registered investment companies. Plans generally report investments at fair value in their financial statements and in regulatory filings with the DOL.

.53 Preparing to meet the requirements of FASB Statement No. 157 will require coordination among plan management, custodians, investment fiduciaries, and auditors. GAAP requires plan management to take responsibility for valuation and the Form 5500 requires assets to be reported at current value. Plan administrators have a fiduciary responsibility to ensure the accuracy of the information reported on the Form 5500. Plan management can delegate but not abdicate their valuation responsibility. Although plan management can outsource the mechanics of the valuation process, they need to retain responsibility for the oversight of the final valuations, including determining the adequacy of the related footnote disclosures.

.54 Because plan sponsors have historically used outside service providers to assist in the valuation of investments, they may not have full insight into the mechanics of the process. Some plan sponsors lack expertise over valuation of investments and will look to their service providers to assist in the process. Undoubtedly clients are at different levels of preparedness when it comes to meeting the requirements of FASB Statement No. 157. Regardless, FASB Statement No. 157 provides an opportunity for greater education of plan management on their responsibilities related to valuation. Service providers frequently offer different levels of services, and plan sponsors need to understand the level of information they are receiving from their service provider.

.55 FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. Generally, FASB Statement No. 157 should be applied prospectively as of the beginning of the year in which it is initially applied. Retrospective application by recognizing a cumulative effect adjustment applies only in specific circumstances as discussed in paragraph 37 of the statement. Readers can access the full text of FASB Statement No. 157 on the FASB Web site at www.fasb.org.

Fair Value Option—FASB Statement No. 159

.56 FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, creates a fair value option under which an organization may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in the statement of activities as those changes occur. An election is made on an instrument-by-instrument basis (with certain exceptions), generally when an instrument is initially recognized in the financial statements. FASB Statement No. 159 is effective as of the beginning of the first fiscal year that begins after November 15, 2007. Earlier adoption is permitted if certain conditions described in paragraph 30 of the statement are met. See FASB Statement No. 159 for further guidance, including presentation and disclosure requirements.

FASB Staff Position AAG INV-1 and SOP 94-4-1

.57 FASB Staff Position (FSP) AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans*, was effective for financial statements for plan years ending after December 15, 2006.

.58 The FSP provided (1) a definition of a *fully benefit-responsive investment contract* and (2) guidance with respect to the financial statement presentation and disclosure of fully benefit-responsive investment contracts. FSP AAG INV-1 and SOP 94-4-1 defines an *investment contract* as (*a*) a traditional or separate account guaranteed investment contract (GIC), (*b*) a bank investment contract, (*c*) a synthetic GIC contract composed of a wrapper contract and the underlying wrapped portfolio of individual investments, or (*d*) a contract with similar characteristics (for example, insurance company general account evergreen group annuity products).

.59 Plans may hold stable value investments through direct contracts with issuers or through a specifically plan-managed account. Plans may also hold stable value investments through beneficial ownership of bank collective funds (CCTs) that own investment contracts. Insurance company pooled separate accounts that hold investment contracts also have similar characteristics. See Technical Questions and Answers (TIS) section 6931.08, "Types of Investments Subject to SOP 94-4, as Amended by FSP AAG INV-1 and SOP 94-4-1" (AICPA, *Technical Practice Aids*).

Financial Statement Presentation and Disclosure Requirements

.60 DC plans, including both health and welfare and pension plans, should report all investments (including derivative contracts) at fair value. However, contract value is the relevant measurement attribute for that portion of the net assets available for benefits of a DC plan attributable to fully benefit-responsive investment contracts. An investment contract is considered fully benefit responsive if certain criteria are met for that contract, as analyzed on an individual basis. See paragraph 3.36 of Audit and Accounting Guide *Employee Benefits Plans*, with conforming changes as of March 1, 2008 for such criteria.

.61 The statement of net assets available for benefits of the plan shall present amounts for (1) total assets, (2) total liabilities, (3) net assets reflecting all investments at fair value, and (4) net assets available for benefits. The amount representing the difference between (3) and (4) shall be presented on the face of the statement of net assets available for benefits as a single amount, calculated as the sum of the amounts necessary to adjust the portion of net assets attributable to each fully benefit-responsive investment contract from fair value to contract value. The statement of changes in net assets available for benefits shall be prepared on a basis that reflects income credited to participants in the plan and net appreciation or depreciation in the fair value of only those investment contracts that are not deemed to be fully benefit responsive.

.62 DC plans, including both health and welfare and pension plans, shall disclose the following in connection with fully benefit-responsive investment contracts in the aggregate:

1. A description of the nature of those investment contracts, how they operate, and the methodology for calculating the interest crediting rate, including the key factors that could influence future average interest crediting rates, the basis for and frequency of determining interest crediting rate resets, and any minimum interest crediting rate under the terms of the contracts. This disclosure should explain the relationship between future interest crediting rates and the amount reported on the statement of net assets available for benefits representing the adjustment for the portion of net assets attributable to fully benefit-responsive investment contracts from fair value to contract value.
2. The average yield earned by the plan for all fully benefit-responsive investment contracts (which may differ from the interest rate credited to participants in the plan) for each period for which a statement of net assets available for benefits is presented. This average yield shall be calculated by dividing the annualized earnings of all fully benefit-responsive investment contracts in the plan (irrespective of the interest rate credited to participants in the plan) by the fair value of all fully benefit-responsive investment contracts in the plan.

   Help Desk—The average yield should be based on the investment income from the investments in the fund (not the crediting rate) as of the last day of the period, annualized, divided by the fair value of the investments as of the last day of the period. In situations in which there are material unsettled trades as of year-end, consideration should be given to adjusting the investment earnings for the estimated amount relating to those unsettled trades.

3. The average yield earned by the plan for all fully benefit-responsive investment contracts with an adjustment to reflect the actual interest rate credited to participants in the plan for each period for which a statement of net assets available for benefits is presented. This average yield shall be calculated by dividing the annualized earnings credited to participants in the plan for all fully benefit-responsive investment contracts in the plan (irrespective of the actual earnings of those investments) by the fair value of all fully benefit-responsive investment contracts in the plan.

   Help Desk—The average yield should be based on the amounts credited to participants in the fund as of the last day of the period, annualized, divided by the fair value of the investments in the fund as of the last day of the period. Note that even though the numerator is the earnings credited to participants in the fund (crediting rate) based on contract value, the denominator is based on the fair value, not the contract value, of the investments.

4. A description of the events that limit the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the plan, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives), including a statement as to whether the occurrence of those events that would limit the plan's ability to transact at contract value with participants in the plan is probable or not probable (the term *probable* is used in the FSP AAG INV-1 and SOP 94-4-1 consistent with its use in FASB Statement No. 5, *Accounting for Contingencies*).
5. A description of the events and circumstances that would allow issuers to terminate fully benefit-responsive investment contracts with the plan and settle at an amount different from contract value.

.63 When the plan invests in a CCT (or similar vehicle) or a master trust that holds fully benefit-responsive investment contracts, the fair value of the investment in the CCT or master trust should be reported in investments on the face of the statement of net assets available for benefits. The amount representing the difference between the fair value and the contract value of the fully benefit-responsive investment contracts held by the CCT or master trust should be presented on the face of the statement of net assets available for benefits and calculated as the sum of the amounts necessary to adjust the portion of net assets attributable to the plan's investment in the CCT or master trust from fair value to contract value. For the master trust, the adjustment only relates to the plan's portion of the master trust invested in the fully benefit-responsive investment contracts. See TIS section 6931.09, "Financial Statement Presentation When a Plan Invests in a Common Collective Trust Fund or in a Master Trust That Holds Fully Benefit-Responsive Investment Contracts" (AICPA, *Technical Practice Aids*). See also the illustrative financial statements in appendix D of this alert.

.64 Plans that directly invest in CCTs, or similar vehicles that hold fully benefit-responsive investment contracts, do not need to include the disclosures detailed in FSP AAG INV-1 and SOP 94-4-1 in the plan's financial statements. Such disclosures would be included in the financial statements of the CCT, in accordance with paragraph 11 of the FSP. For plans that invest in a master trust that holds fully benefit-responsive investment contracts, the notes to the financial statements should include the disclosures required in paragraph 15 of SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans* (AICPA, *Technical Practice Aids*, ACC sec. 10,620), as amended by FSP AAG INV-1 and SOP 94-4-1, related to the fully benefit-responsive investment contracts held by the master trust. See TIS section 6931.10, "Financial Statement Disclosure Requirements When a Plan Invests in a Common Collective Trust Fund or in a Master Trust That Holds Fully Benefit-Responsive Investment Contracts" (AICPA, *Technical Practice Aids*).

Related Auditing Issues

.65 The valuation of investment contracts in accordance with the FSP is the responsibility of the plan sponsor. The plan sponsor can look to an outside service provider to assist in the mechanics of the valuation. The plan sponsor ordinarily should have sufficient information to evaluate and independently challenge the valuation. Plan sponsors may need to work with the various service providers (for example, the trustee or custodian, investment advisor, or recordkeepers) surrounding the investment contracts to determine which service provider will assist in the mechanics of the valuation. Auditors may recommend to plan sponsors that discussions with service providers happen early in the audit planning process to ensure the investment contract valuation will be completed in time for filing deadlines.

.66 For full scope audits of plans with investments in investment contracts, auditors may gain an understanding of the valuation methodology during planning through discussion with clients and service providers and review of valuation documentation. The auditor then reviews and tests the significant assumptions and underlying data used in the valuation of the investment contracts. Additional guidance can also be found in the AICPA practice aid titled *Alternative Investments—Audit Considerations* at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/Alternative_investments.htm.

.67 Many plans invest in investment contracts through bank collective investment funds or CCT funds. Paragraph 7.22 of Audit and Accounting Guide *Employee Benefits Plans* contains examples of substantive procedures for auditing a CCT when performing a full scope audit. If the year-end of the fund is different from the year-end of the plan, the auditor may obtain the financial statements as of the fund's year-end and consider performing the following additional procedures:

- Obtain a confirmation of the plan's position in the fund as of the plan's year-end.
- Obtain the trial balance and portfolio listing of the fund as of the plan's year-end.
- Obtain a SAS No. 70 report on the bank's internal controls during the gap period.
- Perform valuation procedures on the investments held as of the plan's year-end or perform analytical procedures based on indicative data comparing the audited financial statements as of the fund's year-end to the unaudited information as of the plan's year-end, or perform both procedures.

.68 The underlying investments of synthetic investment contracts may consist of investments affected by the subprime or credit crisis events previously described, resulting in an increase in the adjustment from fair value to contract value at year-end. It is important for auditors of plans with investment contracts to take into account the auditing considerations previously described for subprime and other investments affected by recent market events. Auditors may want to read the investment contract agreements and consider what effect any depreciation in value of the underlying investments has on the overall value of the contract and its ability to maintain its benefit-responsiveness features.

.69 For limited scope audits, if the auditor becomes aware that the certified information relating to such investments is inaccurate as a result of valuation or other concerns, further inquiry may be necessary that might result in additional testing or modification to the auditor's report. See paragraphs 7.65–.69 of Audit and Accounting Guide *Employee Benefits Plans* for further guidance on limited scope audits.

Economic and Industry Developments

The State of the Economy

.70 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the entity's financial statements being audited.

.71 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.2 percent in 2007, compared with an increase of 2.9 percent in 2006. According to 2007 fourth-quarter final estimates, real GDP increased at an annual rate of just 0.6 percent, down from third quarter real GDP growth of 4.9 percent.

.72 The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. As of February 2008, the unemployment rate was 4.8 percent, representing approximately 7.4 million people.

.73 The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007 when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates a total of 3 percent to 2.25 percent as of the end of March 2008. The Federal Reserve noted in its March press release that financial markets continue to experience considerable stress and credit continues to tighten for some businesses and households. The housing contraction continues to deepen and labor markets soften. As such, the policy actions taken to decrease rates are meant to promote moderate growth over time and mitigate risks to economic activity while moderating inflation.

Industry Trends and Conditions

.74 Over the past year, employee benefit plans have seen a dramatic change in their portfolios as well as a new understanding of the types of investments held by plans. Due to the current credit crisis, there has been an increase in participant loans taken in 401(k) plans. Many participants are borrowing from their 401(k) plans to pay their monthly mortgage payments. Additionally, there is an increase in the number of participants that are attempting to qualify for hardship withdrawals to pay their mortgages or credit card debt. It is important for plan auditors to be aware of the increase in both participant loans as well as hardship withdrawals.

.75 Secure client information continues to be an issue for both participants and employers who offer employee benefit plans. Stolen computers include client data and present risks not only for the participants but also for the plan sponsor, service providers, and auditors. Practitioners need to implement appropriate security procedures so that personal information such as social security numbers are not included in working papers or on computer supplied information.

.76 New litigation in the past few months is drawing attention to timely complying with participant's instructions. Recently, the U.S. Supreme Court issued its ruling in LaRue v. DeWolff, Boberg & Associates, Inc. The high court disagreed with the Fourth Circuit Court of Appeals' decision that a participant in a 401(k) plan is prohibited from using Section 502(a)(2) of ERISA to recover losses allegedly caused by his or her employer's failure to carry out his or her investment instructions. It is important for auditors to be aware that plan sponsors may be liable for these types of issues.

Audit and Accounting Guide Revision as of March 1, 2008

.77 The AICPA Audit and Accounting Guide *Employee Benefit Plans* has been updated with conforming changes as of March 1, 2008, and includes guidance in planning and performing audits under the risk assessment standards (SAS Nos. 104–111). It also provides additional guidance on the auditor's responsibilities as set forth in SAS Nos. 112–114, including identifying and reporting internal control deficiencies, understanding the link between the auditor's consideration of fraud and the auditor's assessment of risk, and the auditor's communications with those charged with governance.

.78 The Audit and Accounting Guide *Employee Benefits Plans* has also been updated to reflect FASB Statement No. 157, *Fair Value Measurements* and FSP AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans*.

> **Help Desk**—To order Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2008, call the Service Center Operations at (888) 777-7077 or go to www.cpa2biz.com and order product no. 012598kk.

Audit and Attestation Issues and Developments

Client Acceptance and Continuance

.79 Statement on Quality Control Standard No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (AICPA, *Professional Standards*, vol. 2, QC sec. 20 par. .14), provides that policies and procedures should be established 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 audit firm with reasonable assurance that the likelihood of association with a client whose management lacks integrity is minimized. Such policies and procedures should also provide reasonable assurance that the audit firm (*a*) undertakes only those engagements that the firm can reasonably expect to be completed with professional competence and (*b*) appropriately considers the risks associated with providing professional services in the particular circumstances.

.80 The following is a list of risk factors that engagement teams might consider during their client acceptance and continuance discussions related to an employee benefit plan engagement:

- Ineffective monitoring by management (for example, lack of oversight by plan management of outside providers [such as lack of review of reconciliations of trust assets to participant accounts or no independent records maintained by the sponsor to periodically check information provided by the custodian] or an ineffective plan oversight committee)
- Complex or unstable organizational structure (for example, turnover of plan management, oversight committee members, or outside service providers or difficulty in determining which individuals or committees have oversight or fiduciary responsibility for the plan)
- Weak financial reporting skills, failure by the plan administrator or plan management to take appropriate responsibility for the financial statements, or the plan has a material weakness or significant deficiency in its financial reporting process

- Significant related party transactions or transactions with parties in interest, or history of engaging in prohibited transactions (for example, involvement in nonexempt transactions or events or activities [violations of laws, regulations, or plan provisions] that could cause loss of tax-exempt status)
- Plan invests in nonreadily marketable securities (such as limited partnerships and nonpublicly traded employer securities), specialized or unique investments, or engages in securities lending (regardless of the scope of the audit) and management lacks the proper oversight and understanding of such investments, including valuation
- The use of service providers that do not provide a type 2 SAS No. 70 report
- The plan is inherently more complex (such as, health and welfare plans and leveraged ESOPs) and the engagement team lacks the technical skills that are necessary to audit such a plan
- Other inherent risk factors, such as electronic payroll or human resources systems, complex-decentralized control environment, or in-house processing of complex transactions (such as benefit calculations and claims)
- The plan has significant issues with regulatory agencies, pending enforcement matters, or other investigations

SAS No. 70 Issues

.81 Internal control of a benefit plan consists of the controls at the sponsor as well as the controls at applicable service and subservice organizations that perform significant plan functions including but not limited to processing of participant-level transactions such as contributions and distributions, investment custody and valuation, and execution of investment transaction A report prepared in accordance with SAS No. 70, as amended, may be useful in providing user auditors with a sufficient understanding of controls at the service organization to assess the risks of material misstatement in accordance with AU section 314.

.82 It is not uncommon for the service organization's SAS No. 70 report to cover only some of the services used by the plan (for example, the report might cover custodial services but not allocation services) or to not cover activities performed by subservice organizations (for example, the report might not cover services performed by an investment pricing service). The subservice organization may be a separate entity from the service organization or may be related to the service organization. For example, 401(k) recordkeepers often exclude the related party data processing center from their SAS No. 70 reports. The independent auditor's report included in the SAS No. 70 report will typically include language that the report does not cover certain significant service or subservice organizations or systems. For less significant service or subservice organizations or systems, this language will not be included in the auditor's report but will be described elsewhere in the report. In these situations, auditors would gain an understanding of the controls related to the services not covered in the SAS No. 70 report as they relate to the plan's transactions processed by the service or subservice organization that are part of the plan's information system. If the user auditor does not have sufficient information to assess control risk as low or moderate, the plan auditor may decide to perform additional tests of the service or subservice organization's controls or perform additional audit procedures on the plan's financial statements. The auditor may obtain a copy of the subservice organization's SAS No. 70 report if one was issued. See chapter 6 in Audit and Accounting Guide *Employee Benefits Plans* for further guidance.

The Auditor's Communication With Those Charged With Governance

.83 In December 2006, the Auditing Standards Board (ASB) issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) which supersedes SAS No. 61, *Communication With Audit Committees*. This SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and became effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to plans that either have an audit committee or have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.84 SAS No. 114 provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires that significant matters that are communicated with those charged with governance be documented.

Identifying Those Charged With Governance

.85 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the plan and obligations related to the accountability of the plan, including overseeing the plan's financial reporting process. The SAS uses the term *management* to refer to those who are responsible for achieving the objectives of the plan and who have the authority to establish policies and make decisions by which those objectives are to be pursued.

.86 Governance structures vary by plan. The auditor should determine the appropriate person(s) within the plan's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated.

.87 Because there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances. The auditor's understanding of the plan's governance structure and processes obtained in accordance with AU section 314 is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate is not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the plan's governance structure with whom the auditor will communicate.

.88 For a single-employer employee benefit plan, the individual charged with governance may include the audit committee of the plan sponsor or the appropriate entity overseeing the activities of the employee benefit plan, such as the employee benefit committee, administrative committee, investment committee, plan administrator, or responsible party. For a multiemployer plan, those charged with governance will ordinarily be the board of trustees. For further guidance, see AU section 380 and paragraphs 5.05–.12 and 12.38–.46 in Audit and Accounting Guide *Employee Benefit Plans*.

Auditing Plan Fees and Expenses

.89 Most defined benefit plans and many DC plans pay administrative expenses out of plan assets. As plan sponsors look for ways to decrease operating costs, it is becoming more common to amend benefit plans to allow for the payment of the expenses out of the plan. In certain instances, forfeitures are used to pay plan expenses. The auditor's responsibilities with respect to testing administrative expenses are detailed in paragraphs 12.13–.14 of Audit and Accounting Guide *Employee Benefit Plans*. Typically, plan expenses are below materiality levels in a benefit plan audit and, therefore, are not subject to significant detailed testing. Often, auditors obtain reasonable assurance related to expense balances using other audit procedures such as substantive analytics. Auditors need to gain an understanding of the expenses that are allowed to be paid by the plan according to the plan document.

.90 Auditors may also want to be aware of fees paid by one plan on behalf of another plan resulting from errors or inappropriate allocations or fees paid by the plan for certain services (actuarial fees) that may relate to services provided to the plan sponsor. Excessive fees or expenses paid by the plan that are not allowed by the plan document, no matter how immaterial, may be deemed a prohibited transaction requiring further testing and disclosure as described in paragraph 11.13 of Audit and Accounting Guide *Employee Benefit Plans*.

.91 In addition, any fees or expenses paid to related parties need to be considered for disclosure under FASB Statement No. 57, *Related Party Disclosures*. In certain instances, it may be difficult to understand the nature of the expenses being paid by the plan due to the netting of expenses against income or other "hidden" arrangements. In these situations, the auditor may determine that additional inquiries with management and the service providers or review of service provider agreements may assist in understanding the fee arrangements. Also, refer to the DOL-issued publication *Understanding Retirement Plan Fees and Expenses* to better understand and evaluate plan fees and expenses.

Investments Reported as 103-12 Entities as Required by the DOL

.92 For many years, EBSA has focused attention on the valuation of hard-to-value assets (currently, more commonly referred to as *alternative investments*). This year, the EBSA is reviewing alternative investments held by 103-12 investment entities (103-12 IEs) to determine how they are valued and whether they are audited in accordance with generally accepted auditing standards (GAAS).

.93 In the initial phase of this year's effort, EBSA has contacted twenty-four 103-12 IEs, requesting access to working papers supporting their independent audits. Review of these working papers will provide an understanding of the auditor's approach to auditing alternative investments.

.94 A subsequent phase of EBSA's review will involve similar reviews of alternative investments, including investment units of 103-12IEs held directly or indirectly by employee benefit plans. Particular attention will be paid to investments that have been exempted from audit pursuant to DOL Code of Federal Regulations (CFR) Title 29, section 2520.103-8, "Limitation on scope of accountant's examination." EBSA intends to obtain an understanding of the procedures used by plan administrators to properly value, disclose, and monitor their plans' alternative investments.

Eligible Compensation and Payroll Data

Eligible Compensation

.95 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 DC plans and in the determination of benefits in a defined benefit plan. Testing of payroll data may 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. Because this process is generally not included in the payroll testing of the plan sponsor or in SAS No. 70 type 2 reports, a comparison of eligible compensation per the plan document to eligible compensation used in plan operations may be necessary.

.96 The auditor may examine the definition of *compensation* used to determine whether the method used is allowable within the IRC. An employer may use any definition of compensation that satisfies IRC section 414(s), which does not allow a method of determining compensation if that method discriminates in favor of highly compensated employees. Salary deferrals do not have to be included in the definition of compensation if the plan specifically provides for this limitation.

Self-Employed Persons

.97 For plans that include self-employed persons, it is important for the auditor to gain an understanding of the plan's definition of compensation for self-employed persons, procedures for withholding participant deferrals, and the procedures for accumulating the final measurement of net earnings from self-employment for allocations.

.98 Often, benefit plan participants include persons who are classified as self-employed for tax purposes. This includes partners in a partnership, members in an LLC, or sole owners of unincorporated businesses. Plan compensation for these persons is defined as *net earnings from self-employment*. For a partner or LLC member classified as a partner, the starting point for determining compensation is to look on his or her Form 1065, Schedule K-1, "Partner's Share of Income, Deductions, Credits, etc." (line 14). For a self-employed person or the owner of a single-member LLC, this number is derived from information included in Schedule C, "Profit or Loss From Business (Sole Proprietorship)," of his or her Form 1040. As is the case with wages, plans may have additional provisions that affect the amount of net earnings from self-employment that is recognized for plan purposes.

.99 A critical audit consideration is the realization that this figure will frequently vary from the amount of any periodic cash payments made to such persons during the plan year. Salary deferrals may be withdrawn from these periodic payments, but these payments are not compensation for purposes of plan allocations or compliance testing.

Payroll Data

.100 If one audit firm performs both the plan audit and corporate audit, there may be some efficiencies to be achieved surrounding the testing of payroll. Although testing of the payroll area may have been performed in conjunction with the corporate audit, relevant assertions related to payroll for the plan audit may or may not have been tested. When determining the scope of testing for the plan audit, the plan auditor may consider gaining an understanding of the assertions relevant to payroll that were tested during the corporate audit.

.101 For example, payroll testing performed for a corporate audit may not place any emphasis on individual amounts withheld and may be insufficient to satisfy the payroll testing requirements for a plan audit. Often payroll processing is outsourced to an outside service provider that may or may not have an appropriate SAS No. 70 report (see chapter 6 of Audit and Accounting Guide *Employee Benefit Plans* for further discussion of SAS No. 70 reports).

.102 If the plan sponsor has an internal audit department that has performed work on payroll data that is relevant to the audit, and it would be effective to incorporate their work into the audit, AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1), provides guidance on what the auditor needs to consider when making use of the internal auditors' work in an audit.

Actuarial Reports for Defined Benefit Plans

.103 Several economic and demographic assumptions are used in actuarial valuations for defined benefit plans to determine funding requirements and the actuarial present value of accumulated plan benefits in accordance with FASB Statement No. 35. One of the most significant economic assumptions is the discount rate. There are two approaches that can be used to select the discount rate. The most commonly used approach is to reflect the long term expected rate of return on assets. This amount is generally stable from one year to the next. This assumption would reflect anticipated growth of the actual underlying investments in the pension trust. Many employers are changing the mix of investments that have been used historically. For employers that are changing their mix of assets, the actual history of returns is not as relevant as new expectations for the new mix of assets. When an approach of looking at the long term expected return is used, the rate selected will generally be the same as that used for funding purposes. It is important that the plan auditors not assume that the FASB Statement No. 35 discount rate under this approach will be the same as the FASB Statement No. 87, *Employers' Accounting for Pensions*, expected long term rate of return on assets or the FASB Statement No. 87 discount rate. In most cases, the plan discount rate will be different than either of the FASB Statement No. 87 rates. Therefore, auditors may want to take care when determining if the proper rate is disclosed in the benefit plan's financial statements.

.104 The second approach that may be used to select the FASB Statement No. 35 discount rate is to select a rate that reflects an insurance company's purchase rates as of the benefit information date. Because this is a settlement type of rate, it may be similar to (but not necessarily the same as) the FASB Statement No. 87 discount rate. A discount rate selected on this basis can be expected to change from year to year to reflect changes in the long term interest rate markets. As of December 31, 2007, long term interest rates increased significantly. This was largely due to risk factors related to the subprime mortgage crisis. Those plans that base the discount rate on a settlement type rate and that use end-of-year benefit information will see a significant increase in the discount rate. That increase will produce a gain with a resulting decrease in present value of accumulated plan benefits. Plans that use beginning of year information will not experience that impact until 2008.

.105 The most significant demographic assumptions used to determine the actuarial present value of accumulated plan benefits include mortality rates, turnover, retirement age, marriage statistics, and form of payment or type of benefit elections. With the increase in life expectancies, the mortality assumption should include improvements to longevity that were not included in earlier tables. Certain mortality tables used by actuaries include the 1983 GAM, 1994 GAM, UP 1994, and RP 2000 tables. For 2007 calendar year plans, a new mortality table is required as part of the minimum required contribution calculation. This table, which is based on the RP 2000 mortality table, has replaced the 1983 GAM table. Many actuarial reports will refer to this table as the RP 2000 Combined Mortality Table with projections as specified by IRS Regulation 1.412(1)(7)-1. It has been common practice to use the same table for FASB Statement No. 35 purposes as is required for minimum funding purposes. It can therefore be expected that the RP 2000 table with or without the IRS required projections will be used frequently for 2007 audits. Beginning in 2007, the new table that will be required for minimum funding purposes will be based on the RP 2000 table.

.106 Because older mortality tables such as 1983 GAM are becoming outdated and will no longer be used for funding purposes after 2006, auditors may consider challenging the use of such tables for purposes of determining the FASB Statement No. 35 liability beginning in 2007. It is possible that the use of the 1983 GAM table may continue to be acceptable depending on the plan's experience; however, most plans will be changing to use the 1994 GAM, UP 1994, or the recent RP 2000 tables for their mortality assumptions.

.107 Regardless of the assumption used, each assumption must be individually reasonable. Plan administrators ordinarily should review actual plan experience with assumptions used periodically to determine if any changes should be made. The following may also be considered as plan auditors review actuarial valuations:

- Trends and nature of benefit distributions (for example, lump sum versus annuity). A plan that predominantly pays lump sum benefits may have a higher obligation than an equivalent plan that pays annuities. To properly value the plan's liabilities, there must be assumptions used to reflect the cost of the lump sum benefits. If there are only assumptions that reflect annuities, the lump sum benefits may be undervalued.
- Whether there has been a shift in the plan population over time. This could warrant a different assumption for turnover or retirement, for example, if participants are retiring much earlier or later than assumed.
- Whether there have been recent plan mergers or acquisitions. In the case of a plan merger, all assumptions would be reviewed for their continued reasonableness because the assumptions used for one plan may not be appropriate for the plan being merged.
- Whether there have been any plan benefit formula changes or a freezing of the plan. Changes in plan benefits available may affect anticipated turnover and retirement patterns. These assumptions would be reviewed if the plan is amended to change benefits.

- Whether consistent gains and losses are generated each year. If yes, this may indicate that one or more of the assumptions are not reasonable based on actual experience.
- When reviewing an actuarial report, consideration may be given to
  — consistency of benefits accumulated each year (auditors would expect changes if there has been a plan merger, acquisition, a significant plan provision change, or changes to the underlying assumptions).
  — benefit payments in the roll forward of accumulated plan benefits should match the amount per the statement of changes in net assets (to properly match these amounts, it is necessary to understand if the beginning of the year or end of the year information is used for the actuarial valuation).
  — the asset value on the financial statements should match the asset value shown in the actuarial report.
  — inclusion of impact of a change in plan provisions and impact of merger, spin-off, or acquisition.

.108 It is also important to note that the assumption of salary increases may not be relevant for FASB Statement No. 35 because the statement is based on the disclosure of the actuarial present value of accumulated plan benefits, which does not take into account future salary increases. It may have some relevance if the actuary does not have or maintain salary histories for the plan participants and the salary increase assumption is used to estimate prior salary histories.

The Use of Beginning of Year Benefit Information Date

.109 The presentation of the financial statement information and the footnotes are affected by the benefit information date selected for disclosure. The preferred approach is to use an end-of-year benefit information date. If this is done, the present value of accumulated plan benefits will be as of the same date as the net assets. In this case, at a minimum, there will be two statements of net assets available for benefits and one statement of changes in net assets. There will be two corresponding statements (or disclosure in the footnotes) of the present value of accumulated plan benefits and one statement of changes. Examples of this are shown in exhibits D-1, D-2, D-3, and D-4 of Audit and Accounting Guide *Employee Benefit Plans*.

.110 However, if beginning-of-year benefit information is used, the date of the benefit information in the actuarial report may not match the date at which net assets are presented. For example, for financial statements presented as of December 31, 2007, and December 31, 2006, the actuarial valuation will be as of January 1, 2007. For the benefit information to match the statement of net assets, the present value of accumulated plan benefits should be presented as of December 31, 2006 (one day earlier). Typically, this will not cause a material misstatement unless there was a plan amendment that was adopted on or after January 1, 2007, with a January 1, 2007, effective date. In that case, the effect of the amendment must be removed. As shown in Audit and Accounting Guide *Employee Benefit Plans*, when beginning-of-year benefit information is used, 2 statements of net assets and 2 statements of changes would be included. Only a single year of present value of accumulated plan benefits is required with a reconciliation from the prior year. Examples of this are shown in exhibits D-1, D-7, and D-8 of Audit and Accounting Guide *Employee Benefit Plans*.

Allocation Testing for DC Plans

.111 One of the objectives of auditing procedures applied to individual participant accounts of a DC 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. Participant account activity during the year (for example, contributions, income allocations, expense allocations, and forfeiture allocations) would be taken into consideration in the determination of auditing procedures including consideration of reliance on a SAS No. 70 type 2 report, if available. Net appreciation or depreciation is typically not allocated to participant accounts but is derived by the recordkeeping system based on the end of day pricing of investments. Often, dividend and interest income is immaterial to the financial statements taken as a whole. In a limited scope audit, the allocation of investment income to individual accounts is not certified by the trustee or custodian and therefore would be considered for testing by the auditor. One method to test certain allocations is to recalculate activity for individual participants (for example, deferral or matching contributions). Other allocations may be performed electronically by the recordkeeping system, and it may be more efficient to rely on the SAS No. 70 type 2 report to reduce the scope of the substantive testing. Some of the additional substantive procedures the auditor may consider in addition to obtaining the SAS No. 70 type 2 report for participant allocations include

- reconciling the summation of participant accounts by investment option to investment balances.
- testing adjustments to participant accounts during the period.
- testing the participant complaint process including the resolution of complaints.

.112 Based on the results of those procedures as well as the auditor's overall risk assessment of participant accounts, the auditor can determine if additional procedures are required, such as

- performing scanning analytics of participant activity (for example, contributions, benefit payments, and income allocation) during the period or
- confirming allocation activity directly with participants.

See chapter 10 of Audit and Accounting Guide *Employee Benefit Plans* for further discussion of auditing participant data.

Missing Participant Data

.113 With recent trends in plan mergers as a result of corporate actions, a number of plan sponsors have been experiencing difficulties in maintaining all pertinent participant data relating to census data and benefit payments. Often, plan sponsors do not maintain the proper detail supporting the deferred vested benefits for defined benefit plans. Lapses in maintaining data can also be caused by a change in service providers (for example, actuaries or other third-party administrators). ERISA requires plans to maintain records that are detailed enough to determine benefits due or that may become due. When auditors are unable to obtain the necessary information to test participant data or benefit payments, this could be considered a restriction on the scope of the audit. According to AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), restrictions on the scope of the audit, whether imposed by the client or by circumstances (such as the timing of his or her work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records), may require the auditor to qualify his or her opinion or to disclaim an opinion. In these situations, the auditor will need to determine how significant the restriction on the scope of the audit is to the overall engagement to determine the effect on the auditor's report.

.114 The missing participant data issue is exacerbated when there is a change in auditor, especially for defined benefit plans. Often, the predecessor auditor has been auditing the participant data for years and is comfortable with the cumulative audit knowledge. However, if the participant data have not been maintained, the successor auditor may have a scope limitation. Prior to accepting a new benefit plan engagement, auditors may wish to take special care in determining if there are any missing participant data.

.115 Auditors may recommend that the plan sponsor consult with legal counsel and consider contacting the DOL prior to attaching a qualified or disclaimer of opinion relating to a Form 5500 filing for a benefit plan.

Auditing Health and Welfare Plans

.116 This section is intended to describe certain areas unique to health and welfare benefit plans because these plans present unique audit challenges. They continue to be more complex and more expensive to audit than other types of plans. The administration of health claims payments has always been complicated, and the requirements for more timely claims processing, appeal decisions, and the privacy requirements under the Health Insurance Portability and Accountability Act of 1996 (HIPAA) have added to these complexities. Standard audit programs for employee benefit plans should be tailored to the unique nature of health and welfare plans.

.117 Before performing a health and welfare plan audit, it is critical for the auditor to obtain a clear understanding of the plan. It is important to note that the audit requirement is of the plan and not of the trust. Therefore, the auditor needs to understand the benefits offered by the plan and may consider the following:

- Which benefits are fully insured versus self-insured
- Who the providers are and the elements of the contractual arrangement with the plan
- For self-insured claims, how the various claims are administrated and adjudicated; how fees are charged; and if the benefit payment is recognized when the check is written, when the check is presented for payment, or when the check has cleared the bank
- For insured benefits, how the premiums are determined and billed and if the contract requires or provides for premium stabilization reserves or experience-rated adjustments
- What the funding arrangement is for each benefit offered, for example, paid from trust like the voluntary employees' beneficiary association (VEBA), taxable trust, 401(h) account or general assets of plan sponsor, and frequency of payment (daily, monthly, quarterly, or annually)
- What information systems are used to support the plan operations and which of those are in-house systems or outsourced

.118 When answering these questions, the auditor would consider the responses with regard to all covered participants (that is, active participants, dependents, terminated employees under the Consolidated Omnibus Budget Reconciliation Act [COBRA], and retirees). Understanding the various benefits offered, the service providers, and the control environment is integral to developing the audit approach and the sampling methodology.

.119 This section is intended to describe certain areas unique to health and welfare plans and in certain instances to provide examples of audit procedures.[1]

HIPAA Privacy Concerns

.120 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. It places requirements on employer-sponsored group health plans, insurance companies, and health maintenance organizations.

.121 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.

Business Associates Agreements

.122 HIPAA requires that plan sponsors enter into a business associates agreement with any of their service providers that have access to any protected health information (PHI). Accordingly, an auditor is

[1] Some of the example audit procedures may be more extensive than what is required by generally accepted auditing standards.

considered a business associate and, after entering into a business associates agreement, should be permitted access to the necessary information required by professional standards to opine on a plan's financial statements. When asked to sign a business associates agreement, auditors need to take special care in reviewing the agreement.

.123 Sponsors of health and welfare plans frequently hire third party administrators (TPAs) to perform administrative functions for their plans, such as administration of participant claims. Generally, the plan auditor tests a sample of claims processed by the TPA as part of the audit. As a result, confidential information generally is exchanged. Before agreeing to provide this proprietary information and data, TPAs frequently request the plan sponsor or auditor, or both, to sign confidentiality agreements or nondisclosure agreements (NDAs). As with business associates agreements, auditors need to take special care in reviewing nondisclosure agreements. Often, the auditor may not agree with certain language in the agreement, resulting in delays in the audit until mutually agreeable language is determined.

> **Help Desk—**NDAs can take many forms and arise on the audit of all types of plans. For example, some TPAs require the auditor to agree to the terms of an NDA prior to being permitted limited access to electronic databases needed to obtain audit evidence directly from the TPA's Web site. Acceptance of these terms would constitute an NDA.

Audit Documentation

.124 As previously noted, HIPAA requires that plan sponsors enter into a business associates agreement with any of their service providers that have access to PHI. Accordingly, an auditor is considered a business associate and, after entering into a business associates agreement, should be permitted access to the necessary information required by professional standards to opine on a plan's financial statements. HIPAA regulations allow for the auditors' working papers to contain PHI; however, PHI in working papers obligates the auditing firm to comply with the HIPAA privacy laws and business associates agreement provisions to maintain the privacy of the PHI, which includes

- restricting access to the working papers,
- providing an accounting of disclosures of PHI, and
- reporting to the sponsor any misuse of PHI by the accounting firm.

.125 AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), (SAS No. 103) provides guidance to auditors on documentation requirements. See paragraphs 5.80–.87 of Audit and Accounting Guide *Employee Benefit Plans* for guidance.

.126 De-identified health information is not subject to HIPAA. To be considered de-identified under HIPAA, information in working papers may not contain

- names,
- dates (such as birth date, admission date, discharge date, and date of death),
- age if 90 or over,
- social security numbers (or block out all except last 4 digits),
- telephone and fax numbers,
- e-mail addresses,
- medical record numbers,
- health plan beneficiary numbers, or
- account numbers.

Health and Welfare Claims and Potential Problems

.127 When auditing claims, it is not expected that the auditor would have the knowledge of a skilled billing claims specialist or a skilled medical specialist when claims are processed by a third-party administrator. It is important however, that the auditor have a basic understanding of the terms of the plan and have the skill and knowledge to test that claims are being properly adjudicated. The auditor may want to be aware of any processing problems that the plan is experiencing with claims and discuss what the plan is doing to correct these issues with the plan administrator. Examples of potential problems when processing claims include

- unbundling (charging for performance of multiple procedures when only one procedure was performed) or upcoding (charging for a higher level of service than the procedure actually performed),
- fictitious services or unnecessary services performed by providers,
- duplicate claims or duplicate coverage,
- kickbacks,
- nontransmittal of rebates and discounts to the plan, and
- improper denial of claims.

.128 When testing health and welfare claims, some errors typically found include the following:

- *Eligibility*. Testing for eligibility is different from those procedures for a pension or 401(k) plan. In many cases, the person receiving the benefit is different from the actual participant. Audit procedures may include verifying the coverage elected by the participant at the date of service. Many plans allow coverage for a spouse, dependents, or other family members. Most problems with eligibility relate to a participant who terminates and whose eligibility ceased before the date of service for which the claim was filed.
- *Wrong individual*. The claim was paid for the wrong person. This occurs when two or more participants have the same or similar names. Claims are also paid for the wrong family member.
- *Deductibles*. Deductibles are not calculated properly.
- *Accumulators*. Benefits are improperly totaled, which may cause the benefit amount to improperly exceed the maximum benefit.
- *Other errors*. These may occur in the diagnosis code, the Current Procedural Terminology or Healthcare Common Procedure Coding System code,[2] or in the information in the claims form.

Contracts With Benefit Service Providers

.129 For any contracts the plan has with a benefit service provider, the auditor may examine the reconciliation of the amounts due to or from the benefit service provider to determine if the amounts are appropriate. Any amounts due from the benefit provider are typically classified as a receivable in the statement of net assets, and amounts due to the provider for benefits paid would normally be shown in the financial statements as a liability on the statement of net assets. If the benefit payment has not been disbursed, then the amount would typically be included with benefit obligations of the plan.

Rebates Receivable

.130 If there are rebates receivable from a service provider, the auditor may examine those rebates to determine if the correct amount for the appropriate period of time has been properly reflected in the financial

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[2] *Physicians' Current Procedural Terminology* (CPT) is a listing of descriptive terms and identifying five-digit codes for reporting medical services and procedures. The Health Care Financing Administration (HCFA) developed level II and level III codes in its Healthcare Common Procedure Coding System (HCPCS codes) to bill for supplies and services not covered by a CPT code (level I).

statements. In addition, the auditor may gain an understanding of the service contracts and apply procedures to determine if all rebates have been received by the plan. These include rebates from prescription drug programs or excess premiums paid over claims incurred under certain contractual arrangements with insurance companies. The auditor would also consider the propriety of the rebate. For example, if the payment vehicle for the claims receiving the rebate was the VEBA trust account, receipt of the rebate by the plan sponsor and deposit of such rebate into a nontrust account may not be appropriate.

Accumulated Eligibility Credits

.131 Many plans cover participants when they are terminated or otherwise unemployed. Single employer plans often cover up to 30 days after employment ends. Multiemployer plans can cover up to 60 days or longer after employment ends. In the construction industry, where work is seasonal, hour banks are often used to provide insurance coverage for the months when the participant does not work. If the plan permits accumulated eligibility credits, there should be an obligation recorded for those credits. The auditor may determine whether the plan provides for accumulated eligibility credits and, if so, if the obligation has been properly calculated, reported, and disclosed in the financial statements in accordance with paragraph 23 of SOP 01-2, *Accounting and Reporting by Health and Welfare Benefit Plans* (AICPA, *Technical Practice Aids*, ACC sec. 10,830).

Actuarial Data and Census Information

.132 The actuarial data and census information furnished by the health and welfare plan sponsor to the actuary, especially when the plan covers retirees, is as important as the data used in a defined benefit pension plan. The auditor may gain assurance through confirmation or other audit procedures to ensure that the actuarial data and census information furnished to the actuary is complete and accurate.

Stop-Loss Coverage

.133 One way for a plan to protect itself against excessive losses is to purchase stop-loss insurance. Stop-loss insurance can be either specific or aggregate. Specific stop-loss insurance protects the plan against claims that exceed a predetermined maximum per person or per family. All claims above the specific stop-loss amount (for example, $25,000) are normally reimbursed at 100 percent up to a limit contained in the plan. Aggregate stop-loss coverage reimburses the plan when total eligible claims exceed a predetermined aggregate, such as 125 percent of expected claims.

.134 It is important for the auditor to gain an understanding of the stop-loss coverage that a plan has and to test that claims have been properly filed against the policy within the period specified by the policy.

Premium Stabilization Reserves

.135 In some fully insured or minimum premium arrangements, an insurance company may require a contract holder to maintain a premium stabilization reserve. Such reserves are usually adjusted by the insurance company at the end of the policy year. The annual adjustment is often the computed difference, or some factor thereof, between actual claims experience of the insurer and premiums paid by the contract holder. Generally, premium stabilization reserves are held in the general assets of the insurance company and are used to pay future premiums of the contract holder. If the premium stabilization reserve is certain to provide future benefits to the plan, the reserve is reported as an asset of the plan. In some cases, the contract holder may liquidate the premium stabilization reserve via cash payment from the insurance company. In other cases, the premium stabilization reserve is forfeited by the contract holder in the event of termination of coverage. Criteria for realization of the reserve are considered when evaluating the existence of the asset.

Health Savings Accounts and Health Reimbursement Arrangements

.136 Individuals enrolled in certain high-deductible health plans can establish health savings accounts (HSAs) to receive tax-favored contributions (from either the employee or employer). The contribution made to the HSA is distributed on a tax-free basis to pay or reimburse qualifying health expenses. The contribution may be used for future expenses or may be used (on a taxable basis) for nonhealth purposes. Funds held in the HSA can be used to pay premiums for long term care insurance and health insurance premiums while receiving unemployment benefits or continuation benefits under COBRA. The HSA's funds are required to be held by an insurance company or trustee (bank).

.137 When HSAs or health reimbursement arrangements (HRAs) are standalone, they have no audit requirement. However, HSAs and HRAs that are components of a health and welfare plan are subject to audit, as are the other components of that health and welfare plan, provided that the plan in question is subject to ERISA's audit requirement. When made a component of a health and welfare plan that is subject to audit, it is critical to obtain a clear understanding of these arrangements to determine the appropriate accounting treatment and auditing procedures. For example, understand where the sources of funding come from (employers, participants, or both), who has legal title to the amounts in these accounts, how the claims are adjudicated (by employer, self-adjudicated by participant, or other), and whether there is a carryforward provision into the next plan year for unused amounts.

.138 In Field Assistance Bulletins (FABs) 2004-1 and 2006-2, the DOL addressed various questions concerning HSAs, including the issue of whether HSAs established in connection with employment-based group health plans constitute employee welfare benefit plans for purposes of Title I of ERISA. See these FABs and paragraph 4.06 in Audit and Accounting Guide *Employee Benefit Plans* for further information about HSAs and HRAs.

COBRA

.139 Many health and welfare plans are required to provide continuation of benefits upon termination of employment through COBRA. This continuation of benefits may be considered a postemployment or postretirement obligation, depending upon the terms of participation. In accordance with SOP 01-2, the benefit obligation associated with COBRA would be equal to the actuarial present value of the cost of such benefits, less the present value of expected participant contributions for such benefits. Many plans require that participants pay the estimated full cost of health benefits provided under COBRA. In such situations, the net cost to the plan sponsor for such benefits is zero, thus the plan would not recognize an obligation. If the plan sponsor subsidizes the cost of health benefits under COBRA, an obligation should be recognized by the plan to the extent that all criteria required by either FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits* or FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, or both, are satisfied.

.140 In many cases, the collection of COBRA contributions and payment of COBRA benefits are performed by third-party administrators. The administration of these benefits needs to be understood, so accounting for all COBRA activity is included in the financial statements of the plan. In the event that benefits provided by COBRA are self-insured, the obligation for claims incurred but not reported should include COBRA participants.

Notices for COBRA Continuation Health Care Coverage

.141 The DOL has published rules clarifying the requirements for notices under COBRA for employees, employers, and plan administrators. Under COBRA, most group health plans must give employees and their families the opportunity to elect a temporary continuation of their group health coverage when coverage would otherwise be lost for reasons such as termination of employment, divorce, or death. COBRA requires that certain notices be given before individuals can elect COBRA coverage. The plan administrator must give employees and spouses a general notice explaining COBRA when the employees and spouses first become covered under the plan. When an event occurs that would trigger a right to elect COBRA coverage, either the employer or the employee and his or her family members must notify the plan of the event. Finally, when the plan receives this notice, the plan must notify individuals of their COBRA rights and allow them to elect continuation coverage. Model notices contained in the regulation are available for download from the EBSA's Web site at www.dol.gov/ebsa.

Recent Auditing Pronouncements and Related Guidance

.142 Presented in the following table is a list of recently issued auditing pronouncements and related guidance relevant to employee benefit plans. 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. See the "Form 11-K Audits" section of this alert for a discussion of PCAOB standards.

Recent Auditing Pronouncements and Related Guidance	
SAS No. 114 Issue Date: December 2006 (Applicable to audits conducted in accordance with GAAS)	*The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380)
SAS No. 113 Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	*Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1)
SAS No. 112 Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	*Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325)
SAS Nos. 104–111 Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	The risk assessment standards
Interpretation No. 1 Issue Date: March 2007 (Interpretive publication)	"Use of Electronic Confirmations" of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 9330 par. .01–.06)
AICPA Technical Practice Aid TIS section 9100.06 Issue Date: May 2007 (Nonauthoritative)	"The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*)

Recent Auditing Pronouncements and Related Guidance	
TIS section 8350.01 Issue Date: May 2007 (Nonauthoritative)	"Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*)
TIS section 8200 (Nonauthoritative)	*Internal Control* Several Technical Questions and Answers developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111. See the section "AICPA Risk Assessment Standards" in this alert for further details.
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1 Revised: June 2007 (Nonauthoritative)	*Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240)
AICPA PITF PA 07-1 Issue Date: January 2007 (Nonauthoritative)	*Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290)

Communicating Internal Control Related Matters Identified in an Audit

.143 The ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which became effective for audits of financial statements for periods ending on or after December 15, 2006. SAS No. 112 establishes standards and provides guidance on communicating matters related to a plan's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. This SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion). Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued, the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. However, with the adoption of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), the PCAOB redefined these terms, which now differ from SAS No. 112.

- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.

- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies and identifies indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.

- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.
- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.
- Contains illustrative written communications to management and those charged with governance.

.144 The AICPA published Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

.145 See appendix B of this alert for further guidance specific for employee benefit plans.

AICPA Peer Review Developments—Recurring Deficiencies Found in Employee Benefit Plan Audits

.146 The AICPA, working with the 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 recurring deficiencies found in employee benefit plan audits include the following:

- Inadequate testing of participant data
- Inadequate testing of investments, particularly when held by outside parties
- Inadequate documentation of audit procedures in areas such as payroll data, participant data, benefit payments, contributions, prohibited transactions, investment transactions, planning, understanding of internal control, and analytical procedures
- 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, including the description of the method and significant assumptions used to determine fair value, an indication of how the fair value had been determined or the net change in fair value of each significant type of investment, the average yield, a description of the basis for determining the interest rate, and whether the contracts carry a minimum crediting interest rate
- Failure to disclose the amount of forfeited nonvested accounts, party-in-interest transactions, or the reconciliation between the assets reported in the audited financial statements and the assets reported in the Form 5500
- 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
- Inadequate or missing disclosures related to participant data

- Failure to properly report on or include the required supplemental schedules relating to ERISA and the DOL

.147 The Audit and Accounting Guide *Employee Benefit Plans* provides guidance concerning areas of noted deficiencies.

Form 11-K Audits

.148 The Securities and Exchange Commission (SEC) requires employee stock purchase, savings, and similar plans with interests that constitute securities registered under the Securities Act of 1933 to file Form 11-K pursuant to section 15(d) of the Securities Exchange Act of 1934. Plans that are required to file a Form 11-K are deemed to be issuers under the Sarbanes-Oxley Act and must submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the PCAOB.

.149 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by visiting www.cpa2biz.com.

Recent PCAOB Pronouncements and Related Guidance	
PCAOB Auditing Standard No. 5 Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	*An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards")
PCAOB Release 2007-005A (appendix 3) Issue Date: June 2007 (Applicable to audits conducted in accordance with PCAOB standards)	PCAOB conforming amendments to the interim Auditing Standards (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"). In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 3 of PCAOB Release No. 2007-005A at www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf.
PCAOB Release 2007-001 Issue Date: January 2007 (Applicable to audits conducted in accordance with PCAOB standards)	*Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (AICPA, *PCAOB Standards and Related Rules*, "Select SEC-Approved PCAOB Releases")
PCAOB Staff Questions and Answers Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	*Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 100—PCAOB Staff Questions and Answers")

(continued)

Recent PCAOB Pronouncements and Related Guidance	
PCAOB Staff Audit Practice Alert No. 2 Issue Date: December 2007 (Applicable to audits conducted in accordance with PCAOB standards)	*Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 400—Staff Audit Practice Alerts")

Form 8-K Requirements for Form 11-K Filers

.150 For an employee benefit plan required to file Form 11-K, the SEC staff has historically expected a change in a plan's auditor to be reported on Form 8-K; however, plans that filed their financial statements as part of the plan sponsor's annual report (as provided for in Securities Exchange Act of 1934 Rule 15d-21) have not been expected to report changes in its auditors on Form 8-K. This requirement was discussed at the April 4, 2006, AICPA SEC Regulations Committee meeting, and although the SEC staff unofficially stated that all employee stock purchase, savings, or similar plans that change auditors are not required to file a Form 8-K (regardless of whether it files its annual financial statements on Form 11-K or as part of the plan sponsor's annual report), the committee observed that, under Section 1000.08(m), "Notification of the Commission or Resignations and Dismissals from Audit Engagements for Commission Registrants," of the PCAOB Interim Quality Control Standards, an independent registered public accounting firm is required to report the termination of the auditor-client relationship for any SEC registrant, which is defined to include employee benefit plans that file Form 11-K. This communication should be in writing directly to the former client, with a simultaneous copy to the Office of the Chief Accountant (OCA) of the SEC. This letter should be sent by the end of the fifth business day following the firm's determination that the client-auditor relationship has ended (or it may be faxed to OCA at 202-772-9251 with a reference to "PCAOB Letter File"). The SEC staff agreed to discuss its position on Form 8-K reporting by employee benefit plans with the PCAOB staff. Until authoritative guidance is provided by the SEC that provides a specific exemption, public accounting firms should continue to provide these "five-day" letters to comply with PCAOB requirements for a change in auditor of a plan that files a Form 11-K. An employee benefit plan whose financial statements are filed as an amendment to the sponsor's Form 10-K does not meet the definition of an *SEC engagement* and would therefore fall outside the scope of Section 1000.08(m).

Preapproval of Employee Benefit Plan Audits

.151 In December 2005, the SEC issued "Current Accounting and Disclosures Issues in the Division of Corporation Finance" to provide guidance regarding the preapproval of audits of employee benefit plans. Section II.R.3 is summarized in the following paragraph.

.152 An employee benefit plan may be an affiliate of a registrant as its plan sponsor. The SEC's independence rules related to preapproval surround services provided to the issuer and the issuer's subsidiaries but not to services provided to other affiliates of the issuer that are not subsidiaries. Therefore, the independence rules do not require the audit committee of the plan sponsor to preapprove audits of the employee benefit plans, although the audit committee is encouraged to do so. When employee benefit plans are required to file Form 11-K, those plans are separate issuers under the Exchange Act; as a result, those issuers are subject to the preapproval requirements. This preapproval can be provided by either the audit committee of the plan sponsor or the appropriate entity overseeing the activities of the employee benefit plan, such as the trustee, plan administrator, or responsible party. The SEC's rules require that all fees, including fees related to audits of employee benefit plans, paid to the principal auditor be included in the company's fee disclosures, regardless of whether the audit committee of the company preapproved those fees. As part of the exercise to gather the information for the required fee disclosures, the audit committee should be made aware of all fees paid to the principal auditor, including those related to audits of the employee benefit plans. The company may elect to separately indicate in their disclosures those fees paid to the principal auditor that were not subject to the preapproval requirements. Registrants and their auditors are reminded that the financial statements included in a Form 11-K must be audited by an independent auditor who is registered with the PCAOB, and the audit report must refer to the standards of the PCAOB rather than GAAS.

Audit Reports—Following Two Sets of Standards

SEC Requirements

.153 The SEC requires employee stock purchase, savings, and similar plans with interests that constitute securities registered under the Securities Act of 1933 to file Form 11-K pursuant to Section 15(d) of the Securities Exchange Act of 1934. When the Form 11-K is filed separately (not as an exhibit to Form 10-K), it must be filed with the SEC within 90 days after the end of the plan's fiscal year-end; however, if the plan is subject to ERISA, the Form 11-K filing deadline is increased to180 days after the plan's fiscal year-end.

Applicable Audit Standards

.154 Plans that are required to file Form 11-K are deemed to be *issuers* under the Sarbanes-Oxley Act and must submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the PCAOB. These plans may also be subject to ERISA and must submit to the DOL an audit in accordance with GAAS promulgated by the AICPA's ASB. It is our understanding that the SEC will not accept an audit report that references GAAS, and the DOL will not accept an audit report that does not reference GAAS.

Performance and Reporting Requirements

.155 Based on AICPA staff discussions with the SEC and PCAOB staff to seek clarification of the performance and reporting requirements for audits of Form 11-K filers, firms will need to conduct their audits of these Form 11-K plans in accordance with two sets of standards and prepare two separate audit reports: an audit report referencing PCAOB standards for Form 11-K filings with the SEC and a separate audit report referencing GAAS for DOL filings. The PCAOB and SEC staff believe that an opinion issued in accordance with PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") (www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standards_1.pdf), does not allow a reference to GAAS; therefore, a "dual" standard report is not appropriate and will not be accepted by the SEC.

.156 Any questions regarding performance and reporting requirements of audits of financial statements of Form 11-K filers should be directed to the SEC Division of Corporation Finance, OCA at (202) 551-5300. See paragraph 13.19 of Audit and Accounting Guide *Employee Benefit Plans* for an example of an opinion for a Form 11-K audit.

Accounting Issues and Developments

FASB Accounting Standards Codification™

.157 On January 15, 2008, FASB launched the 1-year verification period of the *FASB Accounting Standards Codification*.™ The codification is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. The codification includes all accounting standards issued by a standard-setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force (EITF), and related literature. The codification also includes relevant authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance.

.158 The codification does not change GAAP but rather it reorganizes thousands of GAAP pronouncements into approximately 90 topics. Therefore, the 1-year verification period is not to debate the underlying requirements of GAAP but rather to verify that the codification appropriately captures them and accurately reflects existing U.S. GAAP for nongovernmental entities. The verification period is also a period for constituents to acquaint themselves with the new structure and to submit feedback regarding any issues before the codification content becomes authoritative. At the end of the 1-year verification period, FASB is expected to formally approve the codification as the single source of authoritative U.S. accounting and reporting standards, other than guidance issued by the SEC. At that time, FASB will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the codification will become nonauthoritative. FASB expects to approve the codification in April 2009.

.159 The codification uses a topical structure in which topics, subtopics, and sections are numerically referenced. This effectively organizes the content without regard to the original standard-setter or standard from which the content was derived. The topics of the codification reside in four main areas: presentation, financial statement accounts, broad transactions, and industry guidance. The overall presentation area addresses presentation of financial information but does not address items such as recognition, measurement, or derecognition. For example, topics in this area include income statement, balance sheet, and earnings per share. The financial statement account area presents topics in financial statement order including assets, liabilities, equity, revenue, and expenses. The broad transactions area includes topics related to multiple financial statement accounts that are transaction oriented, such as derivatives and business combinations. The industry area includes guidance unique to an industry or type of activity such as airlines, software, and employee benefit plans. Plan accounting may be found in the following sections of the codification:

- Section 960—Defined Benefit Pension Plans
- Section 962—Defined Contribution Pension Plans
- Section 965—Health and Welfare Benefit Plans

.160 Constituents are encouraged to use FASB's online Codification Research System free of charge and provide feedback to FASB on the codification. The Codification Research System includes general information on how to use the online research system and special features such as Cross Reference Reports, which show where current standards reside in the codification. Readers are encouraged to register and access the codification at www.fasb.org/project/codification&retrieval_project.shtml. Special attention should be paid to where the FASB reconciled conflicts in existing GAAP and to identify any unintentional changes to GAAP.

Unrelated Business Income Tax and FASB Interpretation No. 48

.161 Although qualified benefit plans are not generally subject to taxation, certain activities of a qualified plan may be taxable. In general, unrelated business taxable income (UBTI) of a tax-exempt entity is subject to taxation. UBTI is

a. gross income derived from an unrelated trade or business that is regularly carried on, less

b. allowable deductions directly connected with the trade or business.

.162 With respect to qualified retirement plans, *unrelated trade or business* is defined as any trade or business regularly carried on by the trust or by a partnership of which the trust is a member. This means that a qualified plan can have UBTI due to its investments. For tax-exempt welfare plans, UBTI includes the previous examples. In addition, such plans may be subject to UBTI on their investment income if their assets exceed certain allowable reserves.

.163 Nonleveraged investments, such as government securities, stocks and debt instruments of noncontrolled corporations, mutual funds, and insurance company annuity contracts, do not typically generate UBTI.

However, other nonleveraged investments, such as investments in partnerships, real estate investment trusts, loans or mortgages, and options to buy or sell securities such as short sales or repurchase agreements, may generate UBTI. The most common plans that generate UBTI are health and welfare plans and defined benefit pension plans. However, with the increase of such investments held by DC plans, such plans may begin to be subject to UBTI also.

FASB Interpretation No. 48

.164 FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes*, clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. See FIN 48 for further guidance.

.165 For public enterprises (including nonpublic consolidated entities of public enterprises that apply GAAP), this interpretation is effective for fiscal years beginning after December 15, 2006. For nonpublic enterprises (as defined in paragraph 289 of FASB Statement No. 109), except for nonpublic consolidated entities of public enterprises that apply U.S. GAAP, this interpretation is effective for annual financial statements for fiscal years beginning after December 15, 2007. See FSP FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, for further guidance on the effective date. Earlier adoption is permitted as of the beginning of an enterprise's fiscal year.

Considerations for Employee Benefit Plans

.166 FSP FIN 48-2 has generally deferred the effective date of the application of FIN 48 to fiscal years commencing after December 15, 2007. However, when applied, the standard will require assessment of uncertainty of income tax positions for all open years. As such, the auditor may wish to consider the implications of this standard during 2007 benefit plan audits.

.167 Because benefit plans are generally exempt from income taxes, there are few issues that may trigger the application of FIN 48. The main concern for all plans is the retention of the plan's tax-exempt status. For retirement plans, the existence of the IRS's Employee Plans Compliance Resolution System under Revenue Procedure 2006-27 is generally assumed to meet the conditions of an *administrative practice or precedent* as defined in FIN 48, which can be relied upon to retain the plan's exempt status for all but the most egregious of violations. Note that there is no such relief program for welfare benefit plans.

.168 Notwithstanding this general relief for the plan's tax qualified status, a plan may be faced with issues under FIN 48. These potential issues include, but are not limited to, the following:

- Uncertain tax positions taken by pass-through entities in which the plan has invested that generate material unrelated business income tax to the trust
- The determination of whether a pass-through entity generates unrelated business income to the plan
- The assumptions used in determining the reserves for a welfare benefit plan that is subject to unrelated business income tax due to excess asset accumulations
- The assumptions used by an ESOP of an S corporation to demonstrate satisfaction with the "broadly held" rules of IRC Section 409(p) and the associated exemption from tax on the pass-through income
- The continuation of a welfare benefit plan's tax exempt status

Recent AICPA Independence and Ethics Pronouncements

.169 AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.170 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 161 (March 2008)	*Disclosures about Derivative Instruments and Hedging Activities*
FASB Statement No. 160 (December 2007)	*Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*
FASB Statement No. 141 (revised 2007) (December 2007)	*Business Combinations*
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
FASB Interpretation No. (FIN) 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* FASB Staff Position (FSP) FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, issued in February 2008, defers the effective date of FIN 48 for certain nonpublic enterprises, as defined in the FSP, to the annual financial statements for fiscal years beginning after December 15, 2007.
FASB EITF Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various employee benefit plan topics.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.171 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to employee benefit plans are briefly explained in this alert. The AICPA general *Audit Risk Alert—2007/08* and other AICPA industry-specific alerts contain summaries of recent pronouncements that may not be discussed in this alert. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.

Disclosures About Derivative Instruments and Hedging Activities

.172 In March 2008, the FASB issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged.

Regulatory Developments

2007 Form 5500 Series

.173 On October 10, 2007, the DOL, the IRS, and the PBGC published the 2007 Form 5500 "Annual Return/Report of Employee Benefit Plan" and related instructions.

.174 Modifications to the Form 5500 for plan year 2007 are described under "Changes to Note" in the 2007 instructions. Significant changes include the following:

Modifications to the Form 5500 Annual Report for 2007

- Under the PPA, a new simplified reporting option is available for eligible plans with fewer than 25 participants as of the beginning of the plan year.
- The instructions for voluntary alternative reporting option for certain plans with fewer than 25 participants on page 8 describe this reporting option.
- Under the PPA, separate actuarial information schedules were developed for 2008 plan year filings for single employer plans (Schedule SB) and multiemployer plans (Schedule MB). Accordingly, the Schedule B is not a valid schedule to file with a plan's 2008 Form 5500 annual return/report. A caution added to the 2007 instructions advises that filers required to file a Schedule B cannot use the 2007 forms to satisfy their 2008 filing requirements, and that short plan year filers who must file a Schedule SB or Schedule MB and/or a supplemental attachment to Schedule R for 2008 will have an automatic extension to file their complete Form 5500 until 90 days after the 2008 forms are available to use for filing.
- Under the PPA, some multiemployer pension plans will have to provide for the 2008 plan year certain PPA-required information as an attachment to the Schedule R. A caution added to the 2007 instructions advises multiemployer defined benefit pension plan filers, including short plan year filers, that they cannot use the 2007 Schedule R without the attachment to satisfy their 2008 Form 5500 filing requirements.
- For Schedule B, Section 1.412(l)(7)-1 of the Income Tax Regulations (published February 2, 2007) provides updated mortality tables to be used under IRC section 412(l)(7)(C)(ii) to determine current liability for participants and beneficiaries (other than disabled participants) for plan years beginning on or after January 1, 2007. The 2007 instructions for Schedule B, line 6d, reflect these updated mortality tables and the list of codes used for valuation purposes and for calculating current liability.

- For Schedule B, IRC section 412(l)(10) states that the *unfunded mortality increase*, as defined in IRC section 412(l)(10)(B), is amortized over a period of 10 years beginning with the first plan year for which new mortality tables are applicable (that is, the 2007 plan year). The amount of the unfunded mortality increase will be combined with any outstanding balance of unfunded old liability and reported on line 12g of the 2007 Schedule B. The associated amortization amount will be combined with any unfunded old liability amount and reported on line 12j of the 2007 Schedule B. ***Note:*** For most plans, the unfunded old liability is completely amortized by the first day of the 2007 plan year.

- For Form 5500, the instructions on page 3 for "Special Rules for Certain Plans of Partnerships and Wholly Owned Trades or Businesses" were revised pursuant to the PPA for 1-participant retirement plans in determining the exemption for filing a Form 5500-EZ when total plan assets are $250,000 or less at the end of the plan year beginning on or after January 1, 2007.

Modifications to the Form 5500-EZ Annual Report for 2007

- Under the PPA, the requirements for filing annual returns with respect to 1-participant retirement plans have been modified to ensure that such plans (and any other plans of the employer) with total assets of $250,000 or less as of the close of the plan year beginning on or after January 1, 2007, will not have to file a return for that year upon meeting the 5 conditions under "Who May File Form 5500-EZ" (see "General Instructions").

- Plans beginning on or before December 31, 2006, for which a Form 5500-EZ was required to be filed will not need to continue filing the Form 5500-EZ unless their total plan assets (for 1 or more 1-participant plans, separately or together) exceed $250,000 at the close of the plan year beginning on or after January 1, 2007.

.175 The official government-printed forms are available by calling (800) TAX-FORM (800-829-3676). In addition, EBSA publications may be ordered by calling (866) 444-EBSA (3272). Information copies of the forms, schedules, and instructions are available on the EBSA's Web site at www.efast.dol.gov.

.176 Filers should monitor the ERISA Filing Acceptance System (EFAST) Web site for information on approved software vendors when completing 2006 Forms 5500 by computer and for electronic filing options. Filers may contact the EFAST Help Line for general assistance by calling (866) 463-3278.

2007 Form M-1 for Multiple Employer Welfare Arrangements

.177 On December 12, 2007, the DOL published in the Federal Register the 2007 Form M-1 annual report for multiple employer welfare arrangements (MEWAs). Plan administrators may use EBSA's online filing system to expedite processing of the form.

.178 MEWAs generally are arrangements that offer medical benefits to the employees of 2 or more employers or to their beneficiaries. The annual filing date for the 2007 Form M-1 is March 3, 2008. In addition, administrators can request an automatic 60-day extension to May 2, 2008. The 2007 form is virtually identical to last year's form.

.179 The online filing system is available on EBSA's Web site. It allows filers to complete the form and submit it at no cost. The online form can be completed in multiple sessions and be printed for the filer's records. The Web site includes a user manual, frequently asked questions (FAQs), and a link to submit questions electronically.

> **Help Desk—**To use the online filing process, go to www.askebsa.dol.gov/mewa. Technical assistance for the online filing system is also available by calling (202) 693-8600. Information about the Form M-1 and how to fill it out is available on the Web site or by calling (202) 693-8360. Paper copies of the form are available at www.dol.gov/ebsa (click on "Forms/Doc Requests") or by calling EBSA toll-free at (866) 444-EBSA (3272).

Correspondence From EFAST or the DOL OCA

.180 Plan administrators often receive correspondence from the DOL regarding the Form 5500 filed for their pension and welfare benefit plans. These letters are generated by both the EFAST processing center in Lawrence, Kansas, and the DOL's Office of the Chief Accountant (OCA) in Washington, DC. Auditors are often asked by their clients to assist in the resolution of issues contained in these government letters.

EFAST-Generated Correspondence

.181 Each year, plan administrators complete and submit to the DOL a Form 5500 for each of their qualified employee benefit plans. Large plans (and certain small pension plans) also require an annual audit, and the independent auditor's report and audited financial statements become an integral part of the Form 5500 filing.

.182 Once completed, the Form 5500 is filed with the DOL's EFAST processing center in Lawrence, Kansas. EFAST uses sophisticated electronic technologies to review each filing before acceptance. The DOL, IRS, and the PBGC have created a variety of edit tests designed to check for things such as completeness, accuracy, timeliness, internal consistency, missing schedules or attachments, and failure to answer mandatory questions. If after subjecting Form 5500 filings to these multiagency edit tests deficiencies or discrepancies are identified, the EFAST system generates a letter addressed to the plan administrator that identifies the problem(s) and provides 30 days within which to make any necessary corrections. After 30 days, if the filing remains deficient, EFAST will generate a second letter in a final attempt to perfect the filing. At the end of a second 30-day period, the Form 5500 filings are said to "post" final to the ERISA database. Those filings still containing errors or omissions are flagged for further review by the DOL's OCA, the IRS, and the PBGC.

Correspondence From the OCA

.183 The DOL's OCA has the responsibility for enforcing ERISA reporting and disclosure requirements. This includes ensuring that the Form 5500 filings are filed timely and correctly and determining whether plan audits are performed in accordance with professional auditing and regulatory standards. The OCA routinely queries the ERISA database and targets for review Form 5500 filings that satisfy certain criteria, including those filings in which processing errors went uncorrected and those with improperly prepared auditor's reports. The OCA staff review the Form 5500 filings and also request copies of working papers that support audit engagements. If the OCA staff identifies problems, a formal enforcement process commences with the issuance of a notice of rejection (NOR) against the plan administrator.

.184 Upon receipt of an NOR, the plan administrator has 45 days to make any necessary corrections to the Form 5500 filing. This may involve the auditors having to correct their audit reports or even perform additional fieldwork in audit areas in which work was previously not performed or deemed by the DOL to be insufficient. At the end of the 45-day period, if the Form 5500 filing remains deficient, the DOL issues a notice of intent to assess a penalty (NOI), potentially subjecting the plan administrator to civil penalties of up to $1,100 per day (imposed from the day after the original due date of the filing). As a policy matter, however, most deficiencies are penalized at $150 per day with penalties capped at $50,000.

.185 When plan administrators receive an NOI, they have 35 days to submit to the DOL a statement of reasonable cause, submitted under penalty of perjury, in which they set forth any reasons why the penalty should be abated in part or in full. It is important to note that traditionally the DOL will not consider abatement of any penalties in cases where deficiencies still exist. If the plan administrator fails to comply with the requirements of the NOI, the penalty becomes a final DOL action, and the plan administrator forfeits all appeal rights.

.186 After the DOL reviews the statement of reasonable cause, the DOL issues a notice of determination that contains the final penalty amount assessed against the plan administrator. The plan administrators may choose to pay the penalty amount or, within 35 days as provided for in the letter, file an answer with the administrative law judge that appeals the penalty.

Important Reminders

.187 Plan administrators should make all efforts to respond timely and thoroughly to all correspondence they receive from the EFAST processing center. Failure to do so may result in future enforcement correspondence from the DOL's OCA. The DOL's penalty process contains rigid timeframes, and DOL officials do not have latitude to extend the deadlines contained in any correspondence. Plan administrators should also be aware that they may receive future enforcement correspondence from the IRS or PBGC, or both, regarding any unresolved filing issues.

.188 Plan auditors often assist their clients in responding to the various DOL penalty notices. To respond on behalf of their clients, plan auditors must be authorized to do so pursuant to a duly executed, notarized power of attorney. Any questions regarding the DOL penalty process should be directed to the OCA at (202) 693-8360.

EBSA-Enhanced Programs to Assess Plan Audit Quality

.189 The EBSA continues its enhanced programs aimed at assessing and improving the quality of employee benefit plan audits. According to the EBSA, nearly 50 public accounting firms audit more than 100 plans that cover approximately 80 percent of plan assets subject to audit. The balance of the more than 70,000 ERISA audits is performed by nearly 10,000 different CPA firms, 8,200 of which perform 5 or fewer audits. The EBSA utilizes both top-down and bottom-up strategies in selecting and evaluating ERISA audits.

.190 First, the EBSA conducts periodic inspections of firms with substantial ERISA audit practices. The EBSA staff meet with firm management, review firm policies and procedures that relate to employee benefit plan audits, and conduct onsite reviews of a sample of ERISA audit engagements. This top-down approach will provide the EBSA a more efficient means of evaluating the quality of audit work performed by these large firms and ensure that findings and recommendations are communicated to those in a position to effect any necessary changes. To date, the EBSA has completed five such reviews.

.191 Next, for firms with small to medium-sized employee benefit plan audit practices, the EBSA focuses its in-house work on reviewing copies of selected audit working papers. When circumstances warrant, the scope of the EBSA's reviews is expanded to additional audit areas. To date, the EBSA has conducted approximately 900 of these desk reviews.

.192 In instances in which deficient audit work is identified, the related Form 5500 filings are subject to rejection, and auditors potentially face referral to the AICPA's Professional Ethics Division or State Board of Public Accountancy.

.193 Finally, the EBSA has expanded its enforcement efforts dealing with fiduciary breaches to include determining whether plan auditors may be considered *knowing participants*. An auditor is considered a knowing participant if at least one of the three following elements is present:

- The plan auditor took affirmative action to further the violation.
- The plan auditor helped conceal the violation.
- The plan auditor failed to act when required to do so by applicable professional standards.

DOL Fiduciary Education Initiatives

.194 The DOL is committed to providing employers and service providers with clear and easy-to-access information on how to comply with federal employment laws. Such information and guidance are often referred to as *compliance assistance*, which is a cornerstone of the DOL's mission.

.195 The DOL's fiduciary education initiatives include nationwide educational seminars to help plan sponsors understand rules and meet their responsibilities to workers and retirees, thereby improving their financial security. The DOL's Web site contains archived versions of webcasts of these programs.

.196 The DOL has also developed an e-law tool to increase awareness and understanding about basic fiduciary responsibilities when operating a retirement plan. The ERISA Fiduciary Advisor provides information and answers to a variety of questions about who is a fiduciary and their responsibilities under ERISA. The ERISA Fiduciary Advisor includes links to more detailed information that may be useful to the user, such as links to regulatory text, publications, and organizations.

.197 Also included in the DOL's compliance assistance efforts are the following DOL-issued publications:

- *Meeting Your Fiduciary Responsibilities*
- *Understanding Retirement Plan Fees And Expenses*
- *401(k) Plan Fee Disclosure Tool*
- *Selecting An Auditor For Your Employee Benefit Plan*
- *Selecting And Monitoring Pension Consultants—Tips For Plan Fiduciaries*
- *Tips For Selecting And Monitoring Service Providers For Your Employee Benefit Plan*
- *Reporting and Disclosure Guide for Employee Benefit Plans*

Help Desk—Further information regarding DOL publications and the dates and locations of upcoming educational programs may be found on the EBSA's Web site at www.dol.gov/ebsa.

Delinquent Filer Voluntary Compliance Program

.198 The Delinquent Filer Voluntary Compliance Program (DFVCP) is designed to encourage plan administrators to file overdue annual reports by paying reduced penalties. Established in 1995 and revised in March 2002, the program offers incentives for delinquent plan administrators to voluntarily comply with ERISA's annual reporting requirements.

.199 The address to be used for the DFVCP is

Standard Mail	*Private Delivery Service*
DFVC Program—DOL P.O. Box 70933 Charlotte, NC 28272-0933	DFVC Program—DOL QLP Wholesale Lockbox—NC 0810 1525 West WT Harris Blvd. Charlotte, NC 28262

Program Eligibility

.200 Eligibility in the DFVCP 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. 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 DFVCP because such plans are not subject to Title I.

Program Criteria

.201 Participation in the DFVCP is a 2-part process. First, file with the 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 DFVCP the required documentation and applicable penalty amount. The plan administrator is personally liable for the applicable penalty amount, and, therefore, amounts paid under the DFVCP shall not be paid from the assets of an employee benefit plan.

Penalty Structure

.202 *Per day penalty.* The basic penalty under the program is $10 per day for delinquent filings.

.203 *Per filing cap.* The maximum penalty for a single late annual report is $750 for a small plan (generally a plan with fewer than 100 participants at the beginning of the plan year) and $2,000 for a large plan.

.204 *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 that are required to file annual reports under Title I of ERISA, the maximum applicable penalty amounts would apply for each plan.

.205 *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 IRC 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 DFVCP there is a delinquent annual report for a plan year during which the plan was a large plan.

.206 *Top hat plans and apprenticeship and training plans.* The penalty amount for top hat plans and apprenticeship and training plans is $750.

IRS and PBGC Participation

.207 Although the DFVCP does not cover late filing penalties under the IRC or Title IV of ERISA, the IRS and PBGC agreed to provide certain penalty relief for delinquent Form 5500s filed for Title I plans in which the conditions of the DFVCP have been satisfied.

.208 Questions about the DFVCP 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.

Voluntary Fiduciary Correction Program

.209 The Voluntary Fiduciary Correction Program (VFCP) encourages voluntary compliance by self-correcting violations of the law. The program also helps plan officials understand the law and gives immediate relief from payment of excise taxes under a class exemption.

.210 In April 2006, the EBSA expanded and simplified the VFCP to help employers and their professional advisors voluntarily correct violations of the law for employee benefit plans. This update to the VFCP reflects public comments and includes

- expansion and simplification of eligible transactions;
- streamlined documentation and clarified eligibility requirements;
- a model application form;
- clarification of what constitutes *under investigation*, allowing more entities to qualify for the program; and
- relief from civil penalties for transactions involving health and welfare plans.

.211 Under the VFCP, employers may voluntarily correct specific ERISA violations. Applicants must fully correct any violations, restore to the plan any losses or profits with interest, and distribute any supplemental benefits owed to eligible participants and beneficiaries. A no-action letter is given to plan officials who properly correct violations.

.212 The DOL also provides applicants conditional relief from payment of excise taxes for certain VFCP transactions under a class exemption related to the VFCP. The amended class exemption was also published in the Federal Register in April 2006.

.213 For more information about the VFCP, contact a local EBSA regional office through its toll-free number, (866) 444-EBSA (3272), or visit the DOL online at www.dol.gov/ebsa.

EBSA Outreach and Customer Service Efforts

.214 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.

.215 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 DOL's outreach efforts continue to focus on plan audit quality, the current Form 5500, the EFAST processing system, and other DOL-related developments. Questions regarding these outreach efforts should be directed to the OCA 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.

Timeliness of Remittance of Participant Contributions Remains an Enforcement Initiative for the EBSA

.216 The EBSA continues to focus on the timeliness of remittance of participant contributions in contributory employee benefit plans. Participant contributions are plan assets on the earliest date that they can reasonably be segregated from the employer's general assets, but in no event later than (1) the 15th business day of the month following the month in which the participant contributions are withheld or received by the employer (for pension plans), and (2) 90 days from the date on which such amounts are withheld or received by the employer (for welfare plans).

Reporting of Late Remittances

.217 Failure to remit or untimely remittance of participant contributions constitutes a prohibited transaction under ERISA section 406, regardless of materiality. Such transactions constitute either a use of plan assets for the benefit of the employer or a prohibited extension of credit. In certain circumstances, such transactions may even be considered an embezzlement of plan assets.

.218 Information on all delinquent participant contributions should be reported on line 4a of either Schedule H, "Financial Information" or Schedule I, "Financial Information—Small Plan," of the Form 5500, regardless of the manner in which they have been corrected. In addition, plan administrators should correct the prohibited transaction with the IRS by filing a Form 5330 and paying any applicable excise taxes.

.219 For large plans that are subject to the audit requirement

- Delinquent participant contributions reported on line 4a that constitute prohibited transactions [excluding those that have been corrected under the VFCP and for which the conditions of Prohibited

Transaction Exemption (PTE) 2002-51 have been satisfied, as described below] may be reported on a separate supplemental schedule to be attached to the Form 5500 and reported on by the IQPA.

- ERISA and DOL regulations require additional information to be disclosed in supplemental schedules. Some of this information is required to be covered by the auditor's report. AU section 551 (SAS No. 29), *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1), as amended, provides guidance on the form and content of reporting when the auditor submits a document containing information accompanying 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 Audit and Accounting Guide *Employee Benefit Plans* for further discussion of prohibited transactions.

.220 Plan officials faced with remitting delinquent participant contributions should consider applying to the DOL's VFCP. Plans that fully comply with the program, including satisfaction of the conditions of PTE 2002-51

- will receive a no-action letter issued by the DOL that provides for no imposition of section 502(l) penalties;
- will receive relief from the excise tax provisions of the IRC;
- will continue to report the occurrence and amount of the corrected delinquent remittances on line 4a of either Schedule H or Schedule I (but not on line 4d or Schedule G); and
- are not required to report such transactions as supplemental information if the plan is required to be audited because the transactions are not considered to be prohibited transactions

.221 The EBSA's Web site, www.dol.gov/ebsa, contains useful information about the VFCP, including a fact sheet, an FAQ section, and a sample no-action letter.

Reporting of Delinquent Loan Repayments

.222 Generally speaking, participant loan repayments are not subject to the DOL's participant contribution regulation (29 CFR 2510.3-102). Accordingly, their delinquent remittance is not reported on line 4a of either Schedule H or Schedule I. However, delinquent remittance of participant loan repayments is a prohibited transaction.

.223 In Advisory Opinion 2002-2A, the DOL concluded that, although not subject to the participant contribution regulation, 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, Advisory Opinion 2002-2A 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.

.224 Accordingly, the DOL will not reject a Form 5500 report based solely on the fact that delinquent forwarding of participant loan repayments is included on line 4a of the Schedule H or Schedule I. Filers that choose to include such participant loan repayments on line 4a must apply the same supplemental schedule and IQPA disclosure requirements to the loan repayments as apply to delinquent transmittals of participant contributions.

.225 Delinquent forwarding of participant loan repayments is eligible for correction under the VFCP and PTE 2002-51 on terms similar to those that apply to delinquent participant contributions.

Help Desk—For questions or further information, contact the Office of Regulations and Interpretations at the DOL at (202) 693-8500 or the EBSA's Web site at www.dol.gov/ebsa.

Proposed Safe Harbor for Employee Contributions to Small Pension and Welfare Plans

.226 On February 29, 2008, the DOL announced a proposed rule to provide greater protection for employee contributions deposited to pension and welfare benefit plans with fewer than 100 participants by proposing a safe harbor period of 7 business days following receipt or withholding by employers. The proposal is designed to protect workers by encouraging employers to deposit participant contributions to small plans in a timely manner. It also will provide employers with a higher degree of compliance certainty.

.227 Under the current rules, employers of all sizes must transmit employee contributions to pension plans as soon as they can reasonably be segregated from the general assets of the employer, but no later than the 15th business day of the month following the month in which contributions are received or withheld by the employer. The latest date for forwarding participant contributions to health plans is 90 days from the date on which such amounts are received or withheld by the employer.

.228 The proposed rule would amend the participant contribution rules for plans with fewer than 100 participants by creating a safe harbor period under which participant contributions to a small plan will be deemed to be made in compliance with the law if those amounts are deposited with the plan within seven 7 business days of receipt or withholding.

.229 Before the effective date of the final regulation, the DOL will not assert a violation regarding participant contributions where such contributions are deposited with small plans within the seven business day safe harbor period. In addition, the DOL is requesting information and data regarding a possible safe harbor for plans with 100 or more participants to enable it to evaluate the current contribution practices of these large employers.

.230 The proposed regulation may be viewed at the DOL's Web site at www.dol.gov/ebsa.

Electronic Filing of the Form 5500 and Changes to the 2009 Form 5500

.231 On November 16, 2007, the EBSA, the IRS, and the PBGC published in the Federal Register revisions to the Form 5500 annual return/report for plan year 2009, including a deferral for 1 year of the move to the wholly electronic filing system.

.232 Originally proposed to take effect for plan year 2008, plans and service providers now will have additional time to comply with changes to the 2009 Form 5500 and the change to the wholly electronic filing system. Plans and service providers will not be required to comply with these changes until the due date for the plan's 2009 Form 5500.

.233 Other highlights of the changes include the following:

- A new simplified annual reporting form for small plans with secure, easy to value investments with regulated financial institutions. The DOL estimates that approximately 594,000 of the 629,000 small plans required to file an annual report will be eligible to use the new Form 5500-SF, or *short form*.

- Removal of the IRS-only schedules (Schedules E and SSA) from the Form 5500 annual return/report as a result of the move to the wholly electronic filing system.

- Revision of Schedule C to clarify the reporting requirements and improve the information plan officials receive regarding amounts being received by plan service providers.
- Replacement of Schedule B with Schedule SB and Schedule MB to reflect the changes in reporting and funding requirements for single and multiemployer defined benefit pension plans under the PPA effective for the 2008 plan year.
- Modification of Schedule R to add questions required by the PPA to gather information on pension plan funding and compliance with minimum funding requirements effective for the 2008 plan year but filed as an attachment rather than as actual schedules. These modifications will be effective in standard format for the 2009 plan year.
- Modification of Schedule R to collect data needed by the PBGC to properly monitor the plans it insures effective for the 2008 plan year but filed as an attachment rather than as an actual schedule. These modifications will be effective in standard format for the 2009 plan year.
- Miscellaneous changes to the schedules and instructions to improve and clarify reporting effective for the 2009 plan year.
- Improved financial disclosure by the approximately 16,000 tax sheltered 403(b) annuity plans subject to Title I of ERISA by making the reporting rules for those 403(b) plans on par with 401(k) plans. This will involve the completion of the Form 5500 as a small or large pension plan, depending on the number of participants eligible to participate in the plan as of the beginning of the plan year. The DOL anticipates that most small 403(b) plans will be eligible to use the new Form 5500-SF, and thus will only have to meet that limited filing obligation. See the section "New Filing and Audit Requirements for ERISA-Covered 403(b) Employee Benefit Plans" in this alert for further guidance.

Help Desk—The 2009 Form 5500 package and the related Federal Register notices are available on the EBSA's Web site at www.dol.gov/ebsa.

DOL Abandoned Individual Account Plan Final Regulations and Class Exemption

.234 On April 21, 2006, the DOL published in the Federal Register three regulations to facilitate the termination of, and distribution of benefits from, individual account pension plans that have been abandoned by their sponsoring employers. Significant business events such as bankruptcies, mergers, acquisitions, and other similar transactions affecting the status of an employer too often result in employers, particularly small employers, abandoning their individual account pension plans (for example, 401(k) plans). When this happens, custodians such as banks, insurers, and mutual fund companies are left holding the assets of these abandoned plans but do not have the authority to terminate such plans and make benefit distributions, even in response to participant demands. In these situations, participants and beneficiaries have great difficulty accessing the benefits they have earned.

Overview of Regulations

.235 The regulations establish standards for determining when a plan is abandoned, establish simplified procedures for winding up the plan and distributing benefits to participants and beneficiaries, and provide guidance on who may initiate and carry out the winding-up process.

Plan Abandonment

.236 A plan generally will be considered abandoned if no contributions to or distributions from the plan have been made for a period of at least 12 consecutive months and, following reasonable efforts to locate the plan sponsor, it is determined that the sponsor no longer exists, cannot be located, or is unable to maintain the plan.

Determinations of Abandonment

.237 Only a qualified termination administrator (QTA) may determine whether a plan is abandoned under the regulations. To be a QTA, an entity must hold the plan's assets and be eligible as a trustee or issuer of an individual retirement plan under the IRC (for example, bank, trust company, mutual fund family, or insurance company).

Termination and Winding-Up Process

.238 The regulations establish specific procedures that QTAs must follow, including

- notifying the EBSA prior to and after terminating and winding up a plan;
- locating and updating plan records;
- calculating benefits payable to participants and beneficiaries;
- notifying participants and beneficiaries of the termination and their rights and options;
- distributing benefits to participants and beneficiaries; and
- filing a summary terminal report.

.239 A QTA is not required to amend a plan to accommodate the termination, and the rules include model notices that the QTA may use.

Rollover Safe Harbor for Missing Participants

.240 The regulations establish a fiduciary safe harbor for the investment of rollover distributions from terminated plans to individual retirement accounts (IRAs) for missing participants.

Fiduciary Liability and Annual Reporting Relief

.241 QTAs that follow the regulation will be considered to have satisfied the prudence requirements of ERISA with respect to winding-up activities.

.242 The regulations provide annual reporting relief, under which QTAs are not responsible for filing a Form 5500 annual report on behalf of an abandoned plan, either in the terminating year or any previous plan years. However, the QTA must complete and file a summary terminal report at the end of the winding-up process.

Class Exemption

.243 The exemption would cover transactions where the QTA selects and pays itself

- for services rendered prior to becoming a QTA;
- to provide services in connection with terminating and winding up an abandoned plan; and
- for distributions from abandoned plans to IRAs or other accounts maintained by the QTA resulting from a participant's failure to provide direction.

Administration

.244 The Abandoned Plan Program is administered by the EBSA's national and regional offices. Notifications under the program should be sent by e-mail to qtanotices@dol.gov or by mail to

Abandoned Plan Coordinator
U.S. Department of Labor
Employee Benefits Security Administration
Office of Enforcement
200 Constitution Avenue, NW, Suite 600
Washington, DC 20210
Tel. (202) 693-8466

Contact Information

.245 For information regarding the Abandoned Plan Program, contact the DOL at (866) 444-EBSA (3272). For questions about the regulations, contact the EBSA's Office of Regulations and Interpretations at (202) 693-8500. For questions about the class exemption, contact the EBSA's Office of Exemption Determinations at (202) 693-8540.

DOL Consultant Advisor Program

.246 The EBSA's Consultant Advisor Program is an enforcement initiative that is among the DOL's national priorities for 2008. It focuses on the receipt of improper, undisclosed compensation by pension consultants and other investment advisers. The EBSA's investigations will seek to determine whether the receipt of such compensation violates ERISA because the adviser or consultant used its position with a benefit plan to generate additional fees for itself or its affiliates. The DOL may also need to investigate individual plans to address such potential violations as failure to adhere to investment guidelines and improper selection or monitoring of the consultant or adviser. The Consultant Advisor Program will also seek to identify potential criminal violations, such as kickbacks or fraud.

Independence Request for Information

.247 On September 11, 2006, the EBSA published in the Federal Register a Request for Information (RFI) concerning whether the DOL should amend its guidelines on the independence of accountants who audit employee benefit plans. The RFI contained a list of 15 specific questions. Recognizing that these questions may not address all issues relevant to the independence of accountants who audit employee benefit plans, interested parties were invited to submit comments on other issues that they believe are pertinent to the DOL's consideration of new or additional independence guidelines.

.248 The DOL comment period for the RFI closed on December 11, 2006, and the DOL received 27 comments. The DOL continues to evaluate the comments to identify common themes, and the project remains an important DOL initiative.

DOL Issues Rules on Selecting Annuity Providers for Benefit Distributions From Pension Plans

.249 The PPA required the DOL to issue regulations clarifying that the selection of an annuity contract as an optional form of distribution from an individual account plan is not subject to the "safest available" standard under Interpretive Bulletin 95-1, "Interpretive bulletin relating to the fiduciary standard under ERISA when selecting an annuity provider" (29 CFR 2509.95-1), but is subject to all otherwise applicable fiduciary standards. On September 12, 2007, the DOL published an interim final rule that amends Interpretative Bulletin 95-1 to limit the application of the bulletin to the selection of annuity providers for benefit distributions from defined benefit plans.

.250 In addition, the DOL announced a proposed rule to provide guidance, in the form of a safe harbor, to help fiduciaries prudently choose annuity providers for benefit distributions from individual account plans, such as 401(k) plans.

.251 Under the proposed safe harbor, fiduciaries must

- conduct an objective, thorough, and analytical search to identify and select providers;
- consider the need to engage an expert to assist in its evaluation of providers; and
- appropriately conclude that the annuity provider would be financially able to make all future payments under the contract and that the cost of the contract is reasonable in relation to the benefits and services to be provided under the contract.

.252 A copy of both the interim final and proposed rules may be found at the DOL's Web site at www.dol.gov/ebsa.

New Disclosure Civil Penalty Rules Under ERISA Section 502(c)(7)

.253 On August 10, 2007, the DOL published a direct final rule amending the civil penalty regulation under ERISA section 502(c)(7) to reflect amendments to this section in the PPA. The final regulation implements the DOL's authority to assess civil penalties against plan administrators that fail to give employees notice of the right to sell company stock in their pension plan accounts.

.254 The PPA established rights of plan participants and beneficiaries to sell the company stock in their accounts and reinvest the proceeds into other investments available under a plan. It also required plan administrators to notify participants and beneficiaries of this new right and of the importance of diversifying the investment of retirement account assets.

.255 The amendments authorize the DOL to assess civil monetary penalties against plan administrators that fail to give employees notice of the right to sell company stock in their pension plan accounts. These penalties may range as high as $100 per day against plan administrators for each violation of the new notice requirement.

.256 The new rule may be found at the DOL's Web site at www.dol.gov/ebsa.

EBSA's Interim Final Rule for Distributions to Missing Nonspouse Beneficiaries

.257 On February 15, 2007, the DOL issued an interim final rule requiring the distribution of 401(k)-type benefits for missing nonspouse beneficiaries from terminated plans to be rolled into IRAs.

.258 The PPA amended the IRC to allow the rollover of certain retirement benefits of a deceased participant into a tax-favored inherited IRA created on behalf of a nonspouse beneficiary.

.259 The new rule, and a related proposed class exemption, conforms to the PPA by amending existing distribution requirements for terminated DC plans, including abandoned plans, to require rollovers into inherited IRAs for missing nonspouse beneficiaries.

.260 The interim final rule and model notices for notifying participants or beneficiaries of the plan's termination and distribution options may be found at the DOL's Web site at www.dol.gov/ebsa.

EBSA's Interim Final Rule on Cross-Trading

.261 On February 12, 2007, the DOL published an interim final rule regarding the new statutory exemption on cross-trading in the PPA.

.262 The rule implements a key provision of the PPA that allows plans to benefit from cross-trading while ensuring that fair and equitable procedures are in place to protect workers' retirement assets. Cross-trading is a transaction in which an investment manager uses its authority to sell a security on behalf of one client and to buy that same security on behalf of another client.

.263 The statutory exemption allows investment managers of plans governed by ERISA to execute cross-trades if certain conditions are met, including the adoption of written cross-trading policies and procedures. The interim rule establishes the requirements for the policies and procedures that investment managers must adopt to engage in cross-trades.

.264 The interim final rule may be found at the DOL's Web site at www.dol.gov/ebsa.

Multiemployer Plan Notice

.265 Sections 202 and 212 of the PPA established new funding requirements for multiemployer plans deemed to be in an endangered or critical status. No later than the 90th day of each plan year, an actuary is required to certify to treasury and the plan sponsor

- whether a plan is in endangered status for the plan year and whether the plan is or will be in critical status for the plan year, and
- in the case of a plan that is in a funding improvement or rehabilitation period, whether the plan is making the scheduled progress in meeting the requirements of its funding improvement or rehabilitation plan.

.266 Plans in critical status must include in the notice additional explanations regarding possible reduction of adjustable benefits.

.267 No later than 30 days after a multiemployer plan is certified to be in endangered or critical status, the plan sponsor must provide notice of the endangered or critical status to participants and beneficiaries, the bargaining parties, the PBGC, the IRS, and the DOL.

.268 An actuary's failure to timely certify a plan's status is equivalent to the plan sponsor having failed to file a Form 5500. This subjects the plan administrator to penalties of up to $1,100 per day pursuant to ERISA section 502(c)(2). Also, pursuant to ERISA section 502(c)(8), the plan administrator is subject to penalties of up to $1,100 per day for not adopting a funding or rehabilitation plan.

.269 This requirement is effective for plan years beginning after 2007.

Proposed Disclosure Rules for Multiemployer Pension Plans

.270 On September 14, 2007, the DOL published proposed rules giving participants in multiemployer pension plans, their union representatives, and contributing employers the right to request and receive copies of certain actuarial, financial, and other funding-related documents from their plans.

.271 The new disclosure rules implement provisions of the PPA that require plan administrators of multiemployer plans to furnish upon the written request of participants, beneficiaries, employee representatives, and contributing employers copies of actuarial, financial, and funding-related documents. The plan has 30 days after a request to furnish the documents, which are limited to 1 copy per report within a 12-month period.

.272 The proposed regulation may be found at the DOL's Web site at www.dol.gov/ebsa.

Proposed Civil Penalty Rules Under ERISA Section 502(c)(4)

.273 On December 19, 2007, the DOL published in the Federal Register a proposed regulation for assessing civil penalties against plan administrators that fail to disclose certain documents to participants, beneficiaries, and others as required by ERISA, as amended by the PPA.

.274 The PPA established new disclosure provisions relating to funding-based limits on benefit accruals and certain forms of benefit distributions; plan actuarial and financial reports; withdrawal liability of contributing employers; and participants' rights and obligations under automatic contribution arrangements. The PPA gives the DOL authority to assess civil monetary penalties of up to $1,000 per day against plan administrators for violations of the new disclosure requirements. The proposed regulation sets forth the administrative procedures for assessing and contesting such penalties and does not address substantive provisions of the new disclosure requirements.

.275 The text of the proposal is available on the EBSA's Web site at www.dol.gov/ebsa.

On the Horizon

.276 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.277 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Readers should refer to information provided by the various standard-setting bodies for information.

Standard-Setting Body	***Web Site***
AICPA Auditing Standards Board (ASB)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
Financial Accounting Standards Board (FASB)	www.fasb.org
Governmental Accounting Standards Board (GASB)	www.gasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Overhaul Project—AICPA Audit and Accounting Guide *Employee Benefit Plans*

.278 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Employee Benefit Plans*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1991. During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.

Proposed FASB EITFs and FSPs

.279 ***Proposed FASB EITF Issues.*** Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.280 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

AICPA Employee Benefit Plan Audit Quality Center

.281 The AICPA Employee Benefit Plan Audit Quality Center is a firm-based, voluntary membership center created in March 2003 with the goal of promoting quality employee benefit plan audits. The center now has over 1,500 members in all 50 states, the District of Columbia, the U.S. Virgin Islands, and Puerto Rico.

.282 Reviews performed by the DOL's EBSA continue to show a difference in the quality of ERISA audits performed by center member firms compared with those performed by nonmember firms. As members of the center, firms have available to them tools and resources that are not available from any other source. In addition to providing periodic E-Alerts with information about recent developments affecting employee benefit plan audits, the center has recently made available to its members

- accounting and auditing resource centers in the areas of 403(b) plan audits, SAS No.103, SAS No. 112, the risk assessment standards (SAS Nos. 104–111), stable value investments, and the PPA.
- "Live Forum" and "Roundtable Discussion" member-only conference calls to share important information and answer participant questions on a wide range of technical and practice topics. As an added benefit, the center now offers a CPE option for most calls.
- two new "Topix" primers on cash balance plans and 403(b) plans to help members gain a general understanding of these types of plans.
- three new "Plan Advisories" for members to share with plan stakeholders regarding issues of importance to plan auditors, including the plan sponsor's and trustees' responsibility for monitoring their TPAs, the importance of internal controls, and the plan sponsor's responsibility for valuing their plan investments.

.283 Visit the center Web site at www.aicpa.org/ebpaqc to see a complete list of center members and to preview center benefits. For more information, contact the center at ebpaqc@aicpa.org.

Employee Benefit Plan Resources

.284 The following are various resources that practitioners engaged in the employee benefit plan industry may find beneficial.

Publications

.285 Practitioners may find the following publications useful with respect to employee benefit plans:

- Audit and Accounting Guide *Employee Benefit Plans* with conforming changes as of March 1, 2008) (product no. 012598kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments*, *Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2008) (product no. 012778kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)

- *Checklists and Illustrative Financial Statements for Defined Benefit Pension Plans* (product no. 008997kk) (2008 product no. 008998kk)
- *Checklists and Illustrative Financial Statements for Defined Contribution Pension Plans* (product no. 009007kk) (2008 product no. 009008kk)
- *Checklists and Illustrative Financial Statements for Health and Welfare Benefit Plans* (product no. 009017kk) (2008 product no. 009018kk)
- AICPA Audit Practice Aid *SAS No. 70 Reports and Employee Benefit Plans* (product no. 061061kk)
- *Accounting Trends & Techniques—Employee Benefit Plans* (product no. 006651kk)

AICPA reSOURCE: Accounting and Auditing Literature

.286 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. 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.

Continuing Professional Education

.287 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry. Among the many courses, the following are specifically related to employee benefit plans:

- Audits of 401(k) Plans
- Employee Benefit Plans Audit and Accounting Essentials
- Form 5500: Prepare It Fast—File It Right...The 1st Time
- SAS No. 70 Auditing Guidance

.288 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.289 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com.

Webcasts

.290 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, 2-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. So far in 2008, *Employee Benefit Plans Strategic Briefing* has been archived and is available on CD-ROM. This webcast, held on April 23, 2008, was a live interactive AICPA webcast covering all the hot issues currently affecting employee benefit plans. Participants learned about current accounting, auditing, and regulatory developments, including the effect of recently issued pronouncements on both preparers and auditors of employee benefit plans. Speakers included Marcus J. Aron, CPA; Marilee Lau, CPA; and Michele Weldon, CPA.

Member Service Center

.291 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.292 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9am to 8pm on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

.293 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.

Industry Conferences

.294 The AICPA sponsors an annual Employee Benefit Plans Accounting, Auditing and Regulatory Update Conference in the late fall. This conference is a 2-day high level forum that lets you interact with expert auditors and members of the DOL. The 2008 conference will be held December 11–12, 2008, in Washington DC.

.295 The AICPA also sponsors an annual National Conference on Employee Benefit Plans each spring. This conference is designed to update attendees on recent developments related to employee benefit plans. The 2009 National Conference on Employee Benefit Plans will be held in May 2009. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

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.296 This Audit Risk Alert replaces *Employee Benefit Plans Industry Developments*—2007.

.297 The Audit Risk Alert *Employee Benefit Plans Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to ldelahanty@aicpa.org or write to

Linda C. Delahanty, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

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Appendix A—IRS Limits

	2008	*2007*	*2006*
Defined benefit			
Maximum annual pension	$185,000	$180,000	$175,000
Defined contribution			
Maximum annual addition	46,000	45,000	44,000
401(k) plan			
Maximum elective deferral	15,500	15,500	15,000
403(b) plan			
Maximum elective deferral	15,500	15,500	15,000
457 plans	15,500	15,500	15,000
SIMPLE plans	10,500	10,500	10,000
Qualified plans			
Maximum compensation limits	230,000	225,000	220,000
Highly compensated limits	105,000	100,000	100,000
Officer limits (key employee)	150,000	145,000	140,000
FICA taxable wage base	102,000	97,500	94,200
Employer and employee social security tax	6.20%	6.20%	6.20%

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Appendix B—Evaluating Control Deficiencies in an Employee Benefit Plan Audit (Applying SAS No. 112)

Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), provides guidance to enhance your ability to identify and evaluate control deficiencies during an audit and then communicate to management and those charged with governance those deficiencies that you believe are significant deficiencies or material weaknesses. The nature of the employee benefit plan environment is likely to give rise to the written communications required by SAS No. 112.

The standard has two unconditional requirements:

- The auditor must evaluate identified control deficiencies and determine whether those deficiencies, individually or in combination, are significant deficiencies or material weaknesses.
- The auditor must communicate, in writing, significant deficiencies and material weaknesses to management and those charged with governance. This communication includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

When conducting an audit of historical financial statements, you are not required to perform procedures to identify control deficiencies. However, during the course of the audit, you may become aware of deficiencies in the design or operation of the entity's internal control. Your awareness of control deficiencies will vary with each audit and will be influenced by the nature, timing, and extent of audit procedures performed, as well as other factors. The results of your substantive procedures may cause you to reevaluate your earlier assessment of internal control.

Evaluating Internal Control Deficiencies

A control deficiency may be considered just a deficiency. More severe deficiencies are significant deficiencies, and the most severe deficiencies are material weaknesses.

Definitions of Significant Deficiency and Material Weakness

A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles (GAAP) such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

> **Help Desk**—SAS No. 112 includes a list of areas in which control deficiencies ordinarily are at least significant deficiencies and a list of indicators that a control deficiency should be regarded as at least a significant deficiency and a strong indicator of a material weakness. A material financial statement misstatement that was not identified by management is a strong indicator of a material weakness. SAS No. 112 also contains an appendix that provides examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

The Evaluation Process

You must evaluate the control deficiencies that you have identified and determine whether these deficiencies, individually or in combination with other control deficiencies, rise to the level of significant deficiencies or material weaknesses.

The factors that you should consider when evaluating control deficiencies are likelihood and magnitude. *Likelihood* refers to the probability that a control, or combination of controls, could have failed to prevent or detect a misstatement in the financial statements being audited. *Magnitude* refers to the extent of the misstatement that could have occurred or that actually occurred because misstatements include both potential and actual misstatements.

The following table summarizes how you consider the significance of a deficiency to determine whether it is a control deficiency, a significant deficiency, or a material weakness.

Magnitude of misstatement that occurred, or could have occurred	***Likelihood of misstatement***	
	More than Remote	***Remote***
Quantitatively or qualitatively material	Material weakness	Control deficiency but not a significant deficiency or a material weakness
More than inconsequential but less than material	Significant deficiency but not a material weakness	Control deficiency but not a significant deficiency or a material weakness
Inconsequential (in other words, clearly immaterial)	Control deficiency but not a significant deficiency or a material weakness	Control deficiency but not a significant deficiency or a material weakness

The Prudent Official Test

When you evaluate the significance of a deficiency, the last step in your evaluation is to conclude whether a prudent official, having knowledge of the same facts and circumstances, would agree with your classification of the deficiency.

> **Help Desk—**See the AICPA Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist you in the implementation of this standard and to provide additional guidance on communication requirements including the form, content, and timing of the communication and the discussion with management and others.

SAS No. 112 includes examples of factors that affect the consideration of likelihood and magnitude.

Likelihood

In addition to the factors listed in SAS No. 112 and Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies*, the following are examples of factors for employee benefit plans that may affect the likelihood that a control or combination of controls could fail to prevent or detect a misstatement:

- The nature of the financial statements' accounts, disclosures, and assertions involved. For example, related party transactions may be prohibited transactions and involve greater risk.
- The susceptibility of the related assets or liability to loss or fraud. Investments and benefits paid have a higher susceptibility to loss or fraud.

- The subjectivity and complexity of the amount involved and the extent of judgment necessary to determine that amount. For example, the calculation of the present value of accumulated plans' benefits.
- The cause and frequency of any known or detected exceptions relating to the operating effectiveness of a control. Health benefit payments have a higher likelihood of fraud or irregularity. Operational deficiencies such as nontimely contributions.
- The interaction or relationship of the control with other controls. Effective monitoring controls at the plan sponsor level and how they interact with the service provider (as outlined in the SAS No. 70 report).

Magnitude

Factors that may affect the magnitude of a misstatement that could result in a deficiency or deficiencies in controls include but are not limited to the following:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity in the account balance or class of transactions exposed to the deficiency in the current period or expected in future periods

For employee benefit plans, areas to consider include contributions, claim payments, benefit payments, and investments. When incorrectly used, the application of the definition of *compensation* can result in a higher magnitude (for example, the exclusion of a certain earnings code in error over a period of years could have a material impact).

Generally, the recorded amount is the maximum amount by which an account balance or total of transactions can be overstated. However, because of the potential for unrecorded amounts, there is no upper limit on the amount of potential understatement.

Control Deficiencies, Significant Deficiencies, or Material Weaknesses

Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* provides a general list of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

In addition to the items listed in the alert, the following paragraphs describe circumstances for employee benefit plans that may be control deficiencies, significant deficiencies, or material weaknesses depending upon the likelihood and magnitude of the deficiency.

> **Help Desk—**The items listed here may be used to supplement but not replace those listed in Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies*. This is a companion to, but not a substitute for, the guidance in SAS No. 112 and the alert. Also, when a control deficiency has been identified, management and the auditor should also evaluate the possible mitigating effects of compensating controls. See the SAS for further guidance.

Significant Deficiencies

Deficiencies in the following areas are ordinarily at least significant deficiencies in internal control:

- *Controls over the selection and application of accounting principles that are in conformity with GAAP (having sufficient expertise in selecting and applying accounting principles is an aspect of such controls)*
  - — Improper valuation of investments, especially alternative investments
  - — Plan management must have the ability (methodology and process) to determine reasonableness of actuarial assumptions

- *Controls over nonroutine and nonsystematic transactions*
  - — Lack of controls over plan mergers and spin-offs
  - — Lack of controls over plan terminations and liquidation accounting
  - — Lack of controls over accounting for plan amendments
  - — Lack of controls when changing service providers and ensuring proper information has been transferred to the new service provider

Material Weaknesses

Each of the following circumstances is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- *Ineffective oversight by those charged with governance of the entity's financial reporting and internal control, or an ineffective overall governance structure:*
  - — Plan sponsor has outsourced the administrative functions of the plan with no oversight by management
  - — Plan sponsor does not have the ability to prepare or review the financial statements
  - — Health and welfare plan utilizes a cash account only for the activity of the plan and neither the outside service provider nor the plan sponsor can prepare the financial statements
  - — Ineffective communication of plan changes between plan management and human resources or payroll department, resulting in significant GAAP deficiencies such as not adjusting the plan financial statements for plan merger or other significant transactions
  - — Lack of documentation of meetings held by those charged with governance (making decisions without documentation)
  - — Appropriateness of plan expenses (if material)
- *Restatement of previously issued financial statements to reflect the correction of a material misstatement*. The correction of a misstatement includes misstatements due to error or fraud but not restatements to reflect a change in accounting principle to comply with a new accounting principle or a voluntary change from one GAAP to another. For employee benefit plans, the following situations may cause restatement of the financial statements if material:
  - — For health and welfare plans, auditing and reporting only on the trust activity rather than the plan
  - — Expenses incurred but not reported (IBNR) not accurately calculated or recorded
  - — Failure to record discretionary employer contributions, especially in profit-sharing plans
  - — Errors in census data that result in a material misstatement of obligation information
  - — Benefit payments not calculated in accordance with plan documents
  - — Not recording demutualizations of insurance companies in the proper period
  - — Failure to properly present and disclose investments (such as securities lending activities, master trusts, and alternative investments)
  - — Incorrect income and expense allocations within a master trust
  - — Cash held on deposit by service providers and not recorded for a health and welfare plan
  - — Inappropriate accounting and disclosure for allocated and unallocated contracts
  - — Improper expenses paid by the plan
  - — Medicare subsidy not properly reflected in the financial statements
  - — Incorrect reporting of 401(k) accounts

- — Use of incorrect actuarial information in the plan financial statements, for example, the use of FASB Statement No. 87, *Employers' Accounting for Pensions*, rather than FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, or using FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, rather than FASB Statement No. 112, *Employers' Accounting for Postemployment Benefits—an amendment of FASB Statements No. 5 and 43*
- — Inappropriate expense allocation between multiemployer plans or the sponsoring union
- — Improper booking of premium stabilization reserves

- *Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the entity's internal control.* This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amounts, which is a strong indicator of a material weakness even if management subsequently corrects the misstatement. For employee benefit plans, these are often due to changes in plan design or the implementation of new pronouncements:
  - — IBNR not accurately calculated or recorded
  - — Not reflecting securities lending in the financial statements due to the lack of understanding of such activity and or the lack of understanding of GAAP requirements surrounding such investments
  - — Lack of having the financial expertise in the financial reporting process
  - — For plan mergers, the recording of net appreciation and transfer amounts may be incorrect due to timing of the accounting of the merger

- *An ineffective internal audit function or risk assessment function at an entity for which such functions are important to the monitoring or risk assessment component of internal control, such as for very large or highly complex entities.* For employee benefit plans, this may include the following:
  - — Investing in alternative or complex investments without proper due diligence or consideration for the accounting, reporting, or regulatory requirements
  - — No oversight for monitoring claims paid in a health and welfare plan
  - — For multiemployer plans, improper monitoring of cash received from contributing employers
  - — Ineffective IT controls
  - — For plans with multiple payroll locations, failure to understand the components of eligible compensation or failure to understand the procedures related to timeliness of participant contributions
  - — Failure to understand the complex nature of the relationships between the plan's systems and the service provider's systems (for example, payroll systems to actuary or recordkeeper systems)
  - — SAS No. 70 report with significant testing exceptions that are not mitigated by controls at the plan sponsor

- *For complex entities in highly regulated industries, an ineffective regulatory compliance function.* This relates solely to those aspects of the ineffective regulatory compliance function for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting. When evaluating the severity of such control deficiencies, the auditor should consider whether the entity has controls in place to monitor the impact on the financial statements of laws and regulations relevant to the conduct of the entity's business and should evaluate the severity of the absence of such controls based on the entity's potential to misstate obligations that may arise from such laws or regulations. For employee benefit plans, this may include the following:
  - — Lack of performance of tax compliance testing such as discrimination testing or lack of taking appropriate corrective action when errors are found in such testing

  - — Prohibited transactions such as timeliness of employee contributions or improper transactions with parties-in-interest and fiduciaries
  - — Lack of timely reporting to regulatory agencies (such as the IRS, Department of Labor, and Pension Benefit Guaranty Corporation)

- *Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected (see paragraph 23 of SAS No. 112 for communication requirements in these circumstances).* This could occur if, for example, one individual is primarily responsible for the accounting and internal controls over all cash receipt and cash disbursement transactions. Having one individual with access to the receipt and disbursement of monies does not provide adequate protection over the plan's assets. Management should consider hiring additional staff or reassign some responsibilities to others to ensure proper segregation of duties is maintained. Given the limited nature of accounting procedures necessary on a monthly basis, management may not feel it is cost effective to add staff to these functions.

- *An ineffective control environment.* Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment. For employee benefit plans, this may include the following:
  - — Lack of oversight by the plan sponsor of the service provider, including not obtaining and reviewing a SAS No. 70 report if available
  - — For service providers with no SAS No. 70 reports, no procedures in place at the plan sponsor to monitor and assess control risk at the service provider

Evaluation Questions

In evaluating the severity of a control deficiency, the first step is to determine whether the deficiency is at least a significant deficiency. Some questions to ask yourself when making this determination include the following:

- Is the likelihood that a misstatement of any magnitude could occur and not be detected by the client's controls at least reasonably possible?
- Is the magnitude of a potential misstatement inconsequential or less than inconsequential to the financial statements? A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements.
- Are there complementary or redundant controls that were tested and evaluated that achieve the same control objective?
- Are there compensating controls that were tested and evaluated that limit the magnitude of a misstatement of the financial statements to inconsequential?

If the answers to these questions are all no, then the deficiency is at least a significant deficiency. If the answer to any question is yes, before concluding that the control deficiency is not at least a significant deficiency, ask yourself if prudent officials, having your knowledge of the facts and circumstances, would agree with your conclusion that the deficiency is not at least a significant deficiency.

If a prudent official would consider the control deficiency to be at least a significant deficiency, then you would conclude that the deficiency is at least a significant deficiency.

The next step is to assess whether the deficiency is a material weakness. Some questions to ask yourself in making this determination include the following:

- Is the magnitude of the potential misstatement less than material to the financial statements?
- Are there compensating controls that were tested and evaluated that limit the magnitude of a misstatement of the financial statements to less than material but more than inconsequential?
- Does additional evaluation result in a judgment that the likelihood of a material misstatement of the financial statements is remote?

If the answers to these questions are all no, then the deficiency is a material weakness. If the answer to any question is yes, before concluding that the deficiency is not a material weakness, ask yourself if prudent officials, having your knowledge of the facts and circumstances, would agree with your conclusion that the deficiency is a significant deficiency and not a material weakness, considering the financial statements.

If a prudent official would consider the control deficiency to be a material weakness, then you would conclude that the deficiency is a material weakness.

Illustrative Letter

The following is an illustrative letter for ABC 401(k) Plan with significant deficiencies and material weaknesses. This letter is for illustrative purposes only and should be modified for the individual circumstances of each engagement. The auditor should evaluate the control deficiencies that have been identified to determine whether they rise to the level of a significant deficiency or material weakness. For guidance, see Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies*.

[Firm letterhead]

[Date]

[Addressee]

[Address]

Ladies and Gentlemen:

In planning and performing our audit of the financial statements of ABC 401(k) Plan (the Plan) as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, (US GAAS) we considered the plan's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the plan's internal control. Accordingly, we do not express an opinion on the effectiveness of the plan's internal control.

Our Responsibilities

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies and other deficiencies that we consider to be material weaknesses.

Definitions Related to Internal Control Deficiencies

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects a plan's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the plan's financial statements that is more than inconsequential will not be prevented or detected by the plan's internal control. A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the plan's internal control.

Identified Deficiencies in Internal Control

We consider the following deficiencies to be significant deficiencies in internal control.

Employer Matching Contributions

During our audit procedures, we noted that the plan sponsor, ABC Company, incorrectly calculated the employer match for one participant, causing the participant to receive an excess match for the plan year. Upon further investigation, it was determined that the entire XYZ division was affected by this error. The plan sponsor intends to correct these errors by reducing the next employer match calculation for the affected participants by the amount of the excess match and earnings thereon. We recommend the plan sponsor develop and execute policies and procedures to ensure the proper calculation of employer matching contributions and that these calculations are reviewed by someone other than the individual performing the calculation.

Employee Deferral Contributions

During our audit procedures, we noted that 401(k) deferrals were not withheld from several participants' paychecks during the year due to the timing of the paycheck, setup of pay types in the ADP payroll software, or because the check was a manual check. The plan sponsor will correct these errors by increasing the participant's next deferral by the missed contribution amount along with remitting the missed employer match and lost earnings in the next monthly remittance. We recommend that the plan sponsor develop and execute policies and procedures to ensure the proper calculation of employee deferrals and that these calculations are reviewed by a knowledgeable individual at the plan sponsor because the calculations are performed by a third-party payroll service provider.

It was also noted during our audit procedures that there is some inconsistency in the application of the terms in the plan document relating to the definition of eligible compensation for the purposes of calculating the employee's contribution and the employer's contribution. One participant in our sample made and received contributions based on his compensation including fringe benefits, although fringe benefits are not included in the definition of compensation in the plan document. We noted that this error existed on all participants receiving fringe benefits at that location. The plan sponsor will correct this error by reducing the participant's next deferral by the excess contributions along with reducing the next match for the excess match and earnings thereon. We recommend that the plan sponsor review the setup of the payroll system to ensure all locations are operating in the same manner and are consistent with the plan document.

It was also noted during audit procedures that the rules for hardship distributions were not applied appropriately as required by the plan document. One participant in our contribution sample was required to stop making contributions for the next twelve months after receiving a hardship distribution but then was allowed to continue making contributions when the plan switched recordkeepers. Upon further investigation, it was determined that a control feature at the recordkeeper had not been put in place to stop the deferral contributions where a hardship distribution had been taken. This is not allowable because the plan document states a participant must cease making contributions for twelve months after a hardship distribution is made. We recommend that the plan sponsor review the policies and procedures surrounding the hardship distribution process to ensure all appropriate controls are in place and are operating in accordance with the plan document.

We believe the following deficiencies constitute material weaknesses.

Investments

During our audit, we noted that the client personnel (such as the assistant controller or human resource supervisor) who prepares the financial statements is not knowledgeable regarding the various investment arrangements entered into on behalf of the plan and the financial statement implications of those arrangements. The treasury department has significant knowledge regarding the types of investment arrangements but is not involved in the accounting and reporting functions for the plan. As a result, the plan financial statements prepared did not contain the proper accounting for plan investments and required disclosures under generally accepted accounting principles. For example, it was necessary for the auditor to propose adjustments to the statement of net assets and revisions to the footnote disclosures relating to the plan's security lending arrangement with the trustee.

It is recommended that either (1) the client personnel increase his or her knowledge of the investment arrangements by working with the treasury department or (2) the treasurer become more involved in the financial statement preparation process. In addition, those individuals responsible for preparing the plan's financial statements should increase their knowledge of employee benefit plan accounting and reporting specifically surrounding investments through the use of the AICPA Audit and Accounting Guide *Employee Benefit Plans* or taking outside learning and education courses surrounding employee benefit plan accounting and reporting.

Lack of Financial Statement Knowledge

During our audit, we noted that the client personnel (such as the assistant controller or human resource supervisor) prepares the financial statements using the year-end trial balance provided by the record keeper. However, the trial balance prepared by the record keeper is not prepared on the accrual basis, and it was therefore necessary for the auditor to propose adjusting journal entries to record the contributions receivable and expenses payable at year-end. In addition, it was necessary for the auditor to propose a number of revisions to the footnotes to the financial statements (for example, disclosure of effect of significant plan amendments) to enable the disclosures to be in accordance with generally accepted accounting principles. The client personnel does not appear to have the necessary knowledge and skill to prepare employee benefit plan financial statements in accordance with generally accepted accounting principles.

We recommend that the company utilizes individuals from the corporate finance department with the requisite knowledge and skill in employee benefit plan generally accepted accounting principles to prepare the financial statements. In addition, we recommend that a current disclosure checklist from the AICPA be used to ensure propriety and completeness of the footnotes.

Review of Information Prepared by Third-Party Service Providers

During our audit procedures, we noted that the plan sponsor, ABC Company, did not perform timely reviews of certain information prepared or provided by its third-party service providers. ABC Company is responsible for the prudent oversight and review of all services provided by third parties to the plan. We recommend that the plan sponsor perform various periodic reviews and reconciliations of information provided by your third-party service providers, including (*a*) reconciling total plan assets per the participant detail (the sum of the individual participant account balances) provided by the plan recordkeeper to total plan assets reported by the plan trustee, (*b*) reconcile total contributions made to the plan per ABC Company's general ledger or payroll register to total contributions received by the plan per the trustee, and (*c*) agree individual demographic data included in new employee personnel files to the corresponding information included in the participant detail provided by the plan recordkeeper.

Securities Lending

During our audit procedures, we noted that there was ineffective design and operation of the financial closing and reporting process, resulting in the misapplication of the accounting and disclosure requirements related to securities lending transactions, as governed by FASB Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. We recommend that the plan sponsor review all security lending transactions to ensure that they are properly presented in the plan's financial statements and accompanying footnotes in accordance with FASB Statement No. 140.

We further consider the following matters to be control deficiencies that are of a lesser magnitude than significant deficiencies.

Disbursements

During our audit procedures, we noted one participant in our sample who was paid a distribution based on the account valuation prior to all earnings and contributions being credited to a participant's account and another participant had an error in the calculation of his forfeited balance. The plan sponsor will correct the first error by distributing the remaining balance in the participant's account to him, but the sponsor is not required to make a further distribution related to the second error due to the immateriality of the underpayment. We recommend that the plan sponsor review all distribution requests for accuracy and periodically spot-check reports received from the third-party recordkeeper for any distribution errors.

Plan Management Response

[Insert "Plan Management Response" section if management issues a written response to this communication and such response will be included in a document containing this communication. If this section is included, the following sentence should also be included: "Plan management's written response to the control deficiencies identified herein has not been subjected to our audit procedures, and, accordingly, we express no opinion on it."]

* * *

We have previously discussed our observations and suggestions with the plan sponsor personnel and would be pleased to discuss them in further detail at your convenience to perform any additional study of the matter or to assist you in implementing the recommendations to the extent our independence is not impaired.

This communication is intended solely for the information and use of management, those charged with governance, and others within the plan sponsor [and if applicable, identify any specified regulatory agency] and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

[Firm name]

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Appendix C—Definitions of Certain Investments

The following list includes certain investments as defined by the instructions to the Form 5500.

Master trust. A trust for which a regulated financial institution (bank, trust company, or similar financial institution that is regulated, supervised, and subject to periodic examination by a state or federal agency) serves as trustee or custodian and in which assets of more than one plan sponsored by a single employer or by a group of employers under common control are held.

Common/collective trust (CCT). A trust maintained by a bank, trust company, or similar institution that is regulated, supervised, and subject to periodic examination by a state or federal agency for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer of a controlled group of corporations.

Pooled separate account (PSA). An account maintained by an insurance carrier, which is regulated; supervised; and subject to periodic examination by a state agency, for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer of a controlled group of corporations.

103-12 Entity. An entity that is not a master trust, CCT, or PSA whose underlying assets include plan assets within the meaning of 29 CFR 2510.3-101 of 2 or more plans that are not members of a related group of employee benefit plans.

Registered investment company. An investment firm that is registered with the Securities and Exchange Commission and complies with certain stated legal requirements for the collective investment and reinvestment of assets contributed thereto from investors (employee benefit plans and nonemployee benefit plans).

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Appendix D—Illustrative Financial Statements

The following 2 illustrative financial statements are for

- the hypothetical XYZ Company 401(k) plan that invests in a common/collective trust (CCT), modified to reflect the reporting and disclosure provisions of FSP AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans*.
- the hypothetical XYZ Company 401(k) plan that invests in a master trust, modified to reflect the reporting and disclosure provisions of FSP AAG INV-1 and SOP 94-4-1.

These illustrations do not illustrate other provisions that might apply in circumstances other than those assumed in this example. They also do not illustrate all disclosures required for a fair presentation in conformity with generally accepted accounting principles (GAAP). The presented formats and the wording of accompanying notes are only illustrative and are not necessarily the only possible presentations.

Although GAAP does not require comparative financial statements, Employee Retirement Income Security Act (ERISA) requires a comparative statement of net assets available for benefits. The illustrative financial statements are intended to comply with the requirements of ERISA.

> **Help Desk**—This is not a set of full financial statements but rather just those portions of the financial statements impacted by FSP AAG INV-1 and SOP 94-4-1. For this example, the following items are presented: (1) the statement of net assets available for benefits, (2) the summary of accounting policies note, and (3) the investment contract with insurance company note.

XYZ Company 401(k) Plan—Statement of Net Assets Available for Benefits (CCT)

	December 31,	
	20X1	*20X2*
Assets:		
Investments, at fair value (see Note C)	$9,192,000	$8,005,000
Receivables:		
Employer contribution	14,000	10,000
Participant contributions	52,000	50,000
Total receivables	66,000	60,000
Total assets	9,258,000	8,065,000
Liabilities:		
Accounts payable	10,000	20,000
Accrued expenses	15,000	—
Total liabilities	25,000	20,000
Net assets available for benefits at fair value	9,233,000	8,045,000
Adjustment from fair value to contract value for interest in collective trust relating to fully benefit-responsive investment contracts	(15,000)	(10,000)
Net assets available for benefits	$9,218,000	$8,035,000

See accompanying notes to the financial statements.

Notes to Financial Statements

B. Summary of Accounting Policies Use of Estimates and Basis of Accounting

Use of Estimates and Basis of Accounting

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates that affect the financial statements and accompanying notes. Actual results could differ from those estimates.

As described in Financial Accounting Standards Board Staff Position (FSP) AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans* (the FSP), investment contracts held by a defined contribution plan are required to be reported at fair value. However, contract value is the relevant measurement attribute for that portion of the net assets available for benefits of a defined contribution plan attributable to fully benefit-responsive investment contracts because contract value is the amount participants would receive if they were to initiate permitted transactions under the terms of the plan. The plan invests in investment contracts through a collective trust. As required by the FSP, the statement of net assets available for benefits presents the fair value of the investment in the collective trust as well as the adjustment of the investment in the collective trust from fair value to contract value relating to the investment contracts. The statement of changes in net assets available for benefits is prepared on a contract value basis.

Investment Valuation and Income Recognition

The plan's investments are stated at fair value. Quoted market prices are used to value investments. Shares of mutual funds are valued at the net asset value of shares held by the plan at year-end. Participant loans are valued at their outstanding balances, which approximate fair value. The plan's interest in the collective trust is valued based on information reported by the investment advisor using the audited financial statements of the collective trust at year-end.

Purchases and sales of securities are recorded on a trade date basis. Dividends are recorded on the ex-dividend date.

Payment of Benefits

Benefits are recorded when paid.

XYZ Company 401(k) Plan—Statement of Net Assets Available for Benefits (Master Trust)

	December 31,	
	20X1	*20X2*
Assets:		
Investments in XYZ Company master trust, at fair value (See note C)	$9,192,000	$8,005,000
Receivables:		
Employer contribution	14,000	10,000
Participant contributions	52,000	50,000
Total receivables	66,000	60,000
Total assets	9,258,000	8,065,000
Liabilities:		
Accounts payable	10,000	20,000
Accrued expenses	15,000	—
Total liabilities	25,000	20,000
Net assets available for benefits at fair value	9,233,000	8,045,000
Adjustment from fair value to contract value for interest in XYZ Company master trust relating to fully benefit-responsive investment contracts	(15,000)	(10,000)
Net assets available for benefits	$9,218,000	$8,035,000

See accompanying notes to the financial statements.

Notes to Financial Statements

B. Summary of Accounting Policies

Use of Estimates and Basis of Accounting

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates that affect the financial statements and accompanying notes. Actual results could differ from those estimates.

As described in FSP AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans* (the FSP), investment contracts held by a defined contribution plan are required to be reported at fair value. However, contract value is the relevant measurement attribute for that portion of the net assets available for benefits of a defined contribution plan attributable to fully benefit-responsive investment contracts because contract value is the amount participants would receive if they were to initiate permitted transactions under the terms of the plan. The plan invests in investment contracts through the XYZ Company master trust. The statement of net assets available for benefits presents the fair value of the investment in the master trust as well as the adjustment of the investment in the master trust from fair value to contract value relating to investment contracts. The statement of changes in net assets available for benefits is prepared on a contract value basis.

Investment Valuation and Income Recognition

The plan's investments are stated at fair value. The fair value of the plan's interest in the master trust is based on the specific interest that each plan has in the underlying participant directed investment options. The investments held by the master trust are valued as follows.

Shares of mutual funds are valued at the net asset value of shares held at year-end. Participant loans are valued at their outstanding balances, which approximate fair value. The fair value of the guaranteed investment contract (GIC) is calculated by discounting the related cash flows based on current yields of similar instruments with comparable durations. Individual assets of the synthetic investment contract (synthetic GIC) are valued at representative quoted market prices. The fair value of the wrap contract for the synthetic GIC is determined using the market approach discounting methodology that incorporates the difference between current market level rates for contract level wrap fees and the wrap fee being charged. The difference is calculated as a dollar value and discounted by the prevailing interpolated swap rate as of period end.

Purchases and sales of securities are recorded on a trade date basis. Dividends are recorded on the ex-dividend date.

Payment of Benefits

Benefits are recorded when paid.

E. Investment Contracts

In 20X0, the plan entered into a benefit-responsive investment contract with National Insurance Company (National), held by the master trust. National maintains the contributions in a general account. The account is credited with earnings on the underlying investments and charged for participant withdrawals and administrative expenses. The GIC issuer is contractually obligated to repay the principal and a specified interest rate that is guaranteed to the plan. There are no reserves against contract value for credit risk of the contract issuer or otherwise. The crediting interest rate is based on a formula agreed upon with the issuer, but may not be less than 4 percent. Such interest rates are reviewed on a quarterly basis for resetting.

The plan also entered into a synthetic investment contract (synthetic GIC) in 20X1, held by the master trust. A synthetic GIC is a wrap contract paired with an underlying investment or investments, usually a portfolio, owned by the plan, of high quality, intermediate term fixed income securities. The plan purchases a wrapper contract from financial services institution. A synthetic GIC credits a stated interest rate for a specified period of time. Investment gains and losses are amortized over the expected duration through the calculation of the interest rate applicable to the plan on a prospective basis. Synthetic GICs provide for a variable crediting rate, which typically resets at least quarterly, and the issuer of the wrap contract provides assurance that future adjustments to the crediting rate can not result in a crediting rate less than zero. The crediting rate is primarily based on the current yield-to-maturity of the covered investments, plus or minus amortization of the difference between the market value and contract value of the covered investments over the duration of the covered investments at the time of computation. The crediting rate is most affected by the change in the annual effective yield to maturity of the underlying securities, but is also affected by the differential between the contract value and the market value of the covered investments. This difference is amortized over the duration of the covered investments. Depending on the change in duration from reset period to reset period, the magnitude of the impact to the crediting rate of the contract to market difference is heightened or lessened. The crediting rate can be adjusted periodically and is usually adjusted either monthly or quarterly, but in no event is the crediting rate less than zero percent.

Certain events limit the ability of the plan to transact at contract value with the insurance company and the financial institution issuer. Such events include (1) amendments to the plan documents (including complete or partial plan termination or merger with another plan), (2) changes to plan's prohibition on competing investment options or deletion of equity wash provisions, (3) bankruptcy of the plan sponsor or other plan sponsor events (for example, divestitures or spin-offs of a subsidiary) that cause a significant withdrawal from the plan, or (4) the failure of the trust to qualify for exemption from federal income taxes or any required prohibited transaction exemption under ERISA. The plan administrator does not believe that the occurrence of any such value event that would limit the plan's ability to transact at contract value with participants is probable.

The GIC does not permit the insurance company to terminate the agreement prior to the scheduled maturity date; however, the synthetic GICs generally impose conditions on both the plan and the issuer. If an event of default occurs and is not cured, the nondefaulting party may terminate the contract. The following may cause the plan to be in default:

- A breach of material obligation under the contract
- A material misrepresentation
- A material amendment to the plan agreement

The issuer may be in default if it breaches a material obligation under the investment contract, makes a material misrepresentation, has a decline in its long term credit rating below a threshold set forth in the contract, or is acquired or reorganized and the successor issuer does not satisfy the investment or credit guidelines applicable to issuers. If, in the event of default of an issuer, the plan were unable to obtain a replacement investment contract, withdrawing plans may experience losses if the value of the plan's assets no longer covered by the contract is below contract value. The plan may seek to add additional issuers over time to diversify the plan's exposure to such risk, but there is no assurance the plan may be able to do so. The combination of the default of an issuer and an inability to obtain a replacement agreement could render the plan unable to achieve its objective of maintaining a stable contract value. The terms of an investment contract generally provide for settlement of payments only upon termination of the contract or total liquidation of the covered investments. Generally, payments will be made pro-rata, based on the percentage of investments covered by each issuer. Contract termination occurs whenever the contract value or market value of the covered investments reaches zero or upon certain events of default. If the contract terminates due to issuer default (other than a default occurring because of a decline in its rating), the issuer will generally be required to pay to the plan the excess, if any, of contract value over market value on the date of termination. If a synthetic GIC terminates due to a decline in the ratings of the issuer, the issuer may be required to pay to the plan the cost of acquiring a replacement contract (that is, replacement cost) within the meaning of the contract. If the contract terminates when the market value equals zero, the issuer will pay the excess of contract value over market value to the plan to the extent necessary for the plan to satisfy outstanding contract value withdrawal requests. Contract termination also may occur by either party upon election and notice.

As described in note B, because the GICs and synthetic GICs are fully benefit responsive, contract value is the relevant measurement attribute for that portion of the net assets available for benefits attributable to the GICs and synthetic GICs. Contract value represents contributions made under the contract, plus earnings, less participant withdrawals and administrative expenses. Participants may ordinarily direct the withdrawal or transfer of all or a portion of their investment at contract value.

Average yields for GICs and synthetic GICs	***20X1***	***20X0***
Based on actual earnings	4.6%	4.9%
Based on interest rate credited to participants	4.7%	5.0%

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Appendix E—Employee Benefits Security Administration Field Assistance Bulletins

In the course of audits and investigations by Employee Benefits Security Administration (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 vehicle for communicating technical guidance from the national office. Field Assistance Bulletins (FABs) ensure that the law is applied consistently across the various regions. They also provide the regulated community with an important source of information about the EBSA's views on technical applications of the Employee Retirement Income Security Act (ERISA). All FABs are posted on EBSA's Web site and available to the public.

Help Desk—FABs are available at www.dol.gov/ebsa under "Compliance Assistance."

The following is a listing and brief description of the FABs.

FAB 2002-1	Addresses the fiduciary considerations involved with the refinancing of an employee stock ownership plan loan under section 408(b)(3) of ERISA.
FAB 2002-2	Addresses whether the trustees of two related multiemployer plans were subject to ERISA' fiduciary standards when they amended the plan's trust agreements.
FAB 2002-3	Addresses the fiduciary considerations regarding the use of agreements in which the service provider retains the "float" on plan assets.
FAB 2003-1	Addresses the issue of whether corporate directors and officers may be denied participant loans that might violate securities laws when ERISA requires that such loans be made available to all participants on a reasonably equivalent basis.
FAB 2003-2	Considers the application of EBSA's participant contribution requirements to multiemployer defined contribution pension plans.
FAB 2003-3	Addresses the rules that apply to how expenses are allocated among plan participants in a defined contribution pension plan.
FAB 2004-1	Addresses whether health savings accounts (HSAs) established in connection with employment based group health plans constitute "employee welfare benefit plans" for purposes of Title I of ERISA.
FAB 2004-2	Addresses a fiduciary's duties with respect to missing participants in a terminated defined contribution plan.
FAB 2004-3	Addresses the fiduciary responsibilities of a directed trustee in the context of publicly traded securities.

FAB 2006-1	Addresses the distribution to plans of settlement proceeds relating to late trading and market timing.
FAB 2006-2	Addresses recurring questions about ERISA coverage of HSAs and evolving practices in the offering of HSAs in the workplace.
FAB 2006-3	Addresses interim guidance relating to individual benefit statements and notices of freedom to divest employer securities pursuant to the Pension Protection Act of 2006.
FAB 2007-1	Addresses guidance relating to the investment advice provisions of the Pension Protection Act of 2006.
FAB 2007-2	Addresses how IRS regulations governing 403(b) tax sheltered annuity programs affect the status of such programs under the Department of Labor's (DOL's) safe harbor regulation at 29 C.F.R. § 2510.3 2(f).
FAB 2007-3	Addresses guidance to EBSA's national and regional offices relating to the timeframe for furnishing pension benefit statements by certain individual account plans.
FAB 2007-4	Addresses the circumstances under which supplemental health insurance coverage satisfies the requirements for excepted benefits under sections 732(c)(3) and 733(c)(4) of ERISA.
FAB 2008-1	Addresses the responsibilities of named fiduciaries and trustees of ERISA covered plans for the collection of delinquent employer and employee contributions.
FAB 2008-2	Addresses which types of health promotion or disease prevention programs offered by a group health plan must comply with the DOL's final wellness program regulations and how a plan determines whether such a program is in compliance with the regulations.

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Appendix F—Payroll Auditing

Payroll Auditing

AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), states that the auditor should assume that revenue recognition is an area where fraud could occur in any entity. For employee benefit plans, the primary sources of revenue are income from investments and employer and employee contributions. AICPA Audit and Accounting Guide *Employee Benefit Plans*, with conforming changes as of March 1, 2008, contains chapters detailing audit procedures for investments and employer and employee contributions.

In single-employer employee benefit plans, the auditor can test payroll audits directly. Often, the auditor performs the audit for both the employer and the employee benefit plan, and this enables the auditor to do the testing of the employer's payroll without a great deal of difficulty.

For multiemployer benefit plans, employers contribute to an employee benefit plan based on the provisions of a collective bargaining agreement (CBA) negotiated between a union representing employees in a specified trade or industry and their employers. A multiemployer plan may be local, regional, or national in scope and may bind a few employers or several thousand employers.

What Is a Payroll Audit?

A payroll or compliance audit is an audit of a contributing employer to determine whether the employer has contributed the amount specified by the CBA to a multiemployer plan. Although they are called payroll audits, these examinations are actually agreed-upon procedure engagements. When a plan uses a CPA to perform payroll audits, the plan trustees will agree with the auditor about the records to examine and the steps to perform. The CPA will perform the agreed-upon procedures specified and will write a report addressed to the trustees of the multiemployer plan detailing the findings of the engagement. The agreed-upon procedures report issued will typically be in accordance with AT sections 101–701 (AICPA, *Professional Standards*, vol. 1), as amended.

Purpose of a Payroll Audit

There are two primary purposes of a payroll audit. First is to determine that the employer is complying with the CBA. Only those employees covered by the CBA should be reported. The payroll audit helps ensure that all wages and hours for all covered employees are reported.

The second purpose of a payroll audit is to determine the accuracy of employer contributions. Only by having a payroll audit program of contributing employers can an independent auditor gain assurance that the completeness objective has been fulfilled for employer contributions to the multiemployer plan.

Who Should Perform the Payroll Audits?

Payroll audits can be performed internally by the staff of the multiemployer plan or externally by the auditors performing the audit of the plan, another CPA firm, or another entity specializing in payroll auditing. It does not matter who performs the payroll audits if the CPA firm conducting the audit of the plan has the opportunity to review the working papers of the payroll audits performed to the extent necessary to gain assurance regarding the completeness of employer contributions.

Payroll auditing done in-house can be less expensive if the plan can use its own employees to do the audits. In-house auditors can also be used effectively to educate contributing employers regarding their reporting responsibilities in complying with the CBA.

Other plans prefer to hire outsiders to perform payroll audits. These plans prefer to have someone else handle the employment and training issues of payroll auditors.

Are Payroll Audits Required?

Paragraph 10.09 of Audit and Accounting Guide *Employee Benefit Plans* states that in a multiemployer environment "plan sponsors or trustees may engage the employer's auditor, other outsider auditors, in-house compliance personnel, or others to perform agreed upon procedures to test the completeness of employer contributions." The Department of Labor has suggested that it is difficult to ensure the completeness objective over employer contributions without performing payroll audits and that without an effective payroll audit program, the plan auditor may consider issuing a qualified opinion on the plan's financial statements.

There may be some limited circumstances where payroll audits are not necessary. For example, some plans cover only a few contributing employers and the control system for those employers is effective and can give the external auditor confidence that all employer contributions are being collected.

How Often Should Payroll Audits Be Performed?

Paragraph 10.09 of Audit and Accounting Guide *Employee Benefit Plans* states that "a representative group of contributing employers would be tested each year." Does this mean that every contributing employer will be audited within a 3- or 4-year cycle? While a 3- or 4-year cycle might be acceptable in a small plan, a national plan with thousands of contributing employers would have difficulty in auditing all contributing employers. A random sample program may be utilized in selecting at least some of the employers for audit. In that way, every employer would have the opportunity of being audited.

It is important that plans monitor from year to year the effectiveness of its payroll auditing program. The payroll audit program helps ensure the completeness objective in measuring employer contributions. The plan itself may also be able to conclude that the payroll audit program is operating on a cost-effective basis. If revenue from employer contributions generated as a result of the payroll audit program increases from year to year as a percentage of the costs of the program, then consider increasing the number of audits performed. If revenue is declining as a percentage of costs, then consider reducing the number of payroll audits being performed.

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Appendix G—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues guides, practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org

Web Site Name	*Content*	*Web Site*
Private Company Financial Reporting Committee (PCFRC)	Information on the initiative to further improve FASB's standard-setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov

[*The next page is 8179*.]

AAM Section 8070

State and Local Governmental Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of state and local governments with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

Christopher Cole, CPA, CFE
Technical Manager
Accounting and Auditing Publications

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Edward Chait, CPA	

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your state and local government audits. This alert can also be used by a government's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory 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 financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). Further, if your state or local government audit is performed under *Government Auditing Standards* issued by the Comptroller General of the United States of America (also referred to as the Yellow Book or generally accepted government auditing standards [GAGAS]) or Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, you should refer to AICPA Audit Risk Alert Government Auditing Standards *and Circular A-133 Audits—2008/09* (product no. 022458kk). These alerts can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 State and local governments may be subject to specific risks of material misstatement arising from the nature of their activities, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies and the related operational or business risks that may result in material misstatement of the financial statements. These risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the government's operations is also dynamic, and the entity's strategies and objectives change over time. An understanding of operational or business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all such risks. Most operational or business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all such risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the governmental entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the opinion unit level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the National Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the entity's financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.2 percent in 2007, compared with an increase of 2.9 percent in 2006. According to 2008 first-quarter preliminary estimates, real GDP increased at an annual rate of 0.9 percent, which is up slightly from the 0.6 percent rate in the fourth quarter of 2007.

.11 The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. As of April 2008, the unemployment rate was 5.0 percent, representing approximately 7.6 million people.

.12 The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007 when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates a total of 3.25 percent to 2.00 percent as of the end of April 2008. The Federal Reserve noted in its April press release that financial markets continue to experience considerable stress and credit continues to tighten for some businesses and households. The housing contraction continues to deepen and labor markets soften. As such, the policy actions taken to decrease rates are meant to promote moderate growth over time and mitigate risks to economic activity while moderating inflation.

The State of the States' Economy

.13 The Nelson A. Rockefeller Institute of Government (institute) publishes frequent updates on state fiscal conditions. The institute's fiscal report dated January 30, 2008, at www.rockinst.org/WorkArea/showcontent.aspx?id=13894, focuses on concerns over a recessionary economy and the likely impact on state government finances, and includes these highlights:

- State government finances are linked inextricably to the economy; and, after six years of expansion, the national economy has weakened, and many believe the country is, or will soon be, in recession.
- The status of the national financial markets turmoil, the crisis in the housing markets, and employment issues are affecting state economies.
- State finances are showing the effects of the weakening economy. The institute's most recent State Revenue Report showed that state tax revenue declined by 0.6 percent, after adjustment for inflation, the first such decline in more than four years.
- While revenues from personal income taxes have remained healthy, growth in sales tax revenues has slowed and revenue from corporate income taxes has fallen.
- States that rely heavily on income tax from capital gains will likely be more affected as a result of the typical decline in this income during a recessionary period. States that rely on a portfolio of different taxes are likely to have less volatility.
- According to the Center on Budget and Policy Priorities, 16 states have announced budget gaps resulting from revenue shortfalls totaling more than $30 billion and another 8 states have announced gaps yet to be quantified.

.14 The report concludes that during recessionary periods, states may be forced to spend more on social welfare programs, but overall spending increases will likely be constrained by limited revenues. The deeper the economic downturn, the more states will be forced to consider spending cuts and staff reductions. This belt-tightening by state governments will likely further dampen the national economy considering that state and local governments account for nearly 9 percent of national GDP.

Fiscal Sustainability Challenges for All Levels of Government

.15 The U.S. Government Accountability Office (GAO) has released a series of reports alerting the public of the fiscal sustainability challenges facing all levels of government and issuing a nationwide call for stewardship. Over the past two years, the U.S. Comptroller General has participated in a series of town hall-style forums around the country, called the "Fiscal Wake-Up Tour," discussing the federal government's current deficit and the challenges posed by the long-term trends facing our nation. In addition to this Fiscal Wake-Up Tour, a number of related reports have been issued by the GAO over the past several months dealing with the fiscal challenges to the federal government and state and local governments. These reports include the following:

- *A Call for Stewardship: Enhancing the Federal Government's Ability to Address Key Fiscal and Other 21st Century Challenges* (GAO-08-93SP)
- *State and Local Governments: Growing Fiscal Challenges Will Emerge during the Next 10 Years* (GAO-08-317)

.16 In his letter introducing the Call for Stewardship report, former Comptroller General David M. Walker stated, "our nation faces a range of forces and key sustainability challenges that will require action by elected officials in order to keep America great for current and future generations." The report cites the tremendous growth of the U.S. Government since its beginnings in the eighteenth century and concludes that the fiscal sustainability of the federal government is in question and that without meaningful action by 2040 the federal government could only have the resources to do little more than mail out social security checks and pay interest on the federal debt. The report indicates that budget experts agree that the growing entitlement costs for "mandatory spending programs" such as Social Security, Medicare, and Medicaid, absent fundamental reforms, are fiscally unsustainable. In addition, a range of current and emerging issues are requiring significant federal government attention and resources, including health care, energy dependence, environmental protection, and homeland security. In summary, the report concludes that the American government and its citizens will need to conduct a top-to-bottom review of all federal programs and policies and make tough decisions on which federal activities remain priorities and which should be overhauled or even eliminated. Clearly, these issues at the federal level affect the fiscal health of state and local governments.

.17 In its report on state and local governments, the GAO calls our attention to the fact that the growing fiscal challenges and the risks those challenges pose are more pervasive than the national level. The GAO wants individuals of all ages to understand that these growing fiscal challenges go deeper than just at the national level. According to Walker,

> Fiscal sustainability presents a national challenge shared by all levels of government. The federal government and state and local governments share in the responsibility of fulfilling important national goals, and these sub-national governments rely on the federal government for a significant portion of their revenues. As happens at the federal level, these sub-national governments may also face serious fiscal stress in the future.

.18 According to the GAO report, the state and local government sector consists of 50 state governments and 87,525 local governments. These local governments include 3,034 county governments, 19,429 municipal governments, 16,504 townships, 13,506 school districts, and 35,052 special districts. State and local governments provide vital services to citizens, such as law enforcement, public education, and water and sewage treatment. Local governments derive their authority from the states, and the powers and responsibilities granted to local governments vary considerably. For example, while states generally provide authority to local governments to tax real property, local governments vary in their authority to levy other types of taxes, such as personal income or sales taxes. It is easy to see how many individuals' livelihoods are touched by not only the national fiscal challenges, but the trickle down impact found at the state and local level.

.19 The full reports can be found on the GAO Web site under the report numbers previously noted at www.gao.gov.

Other Industry Trends and Conditions

Subprime Mortgage Crisis and Government Entities

.20 The financial crisis surrounding subprime mortgages has made its way to the steps of state capitols and city halls. Over the years, many state and local governments and their investment pools have turned to investments in mortgage-backed commercial paper and other mortgage-backed securities to broaden their investment portfolio and improve investment returns. However, the recent turmoil in the subprime mortgage market and the downgrading of certain investment funds, such as those with assets concentrated in mortgages, have caused many state and local governments to reevaluate their investment portfolio risks; certain governments have halted their purchases of such investment funds. One example of the effect of the subprime mortgage crisis on local governments is a situation where a county government was informed that credit-rating agencies had downgraded two investments totaling more than $100 million held within their investment pool. This county government not only invests its own resources, but also serves as an investment pool manager for other governmental entities or jurisdictions within the county. In response to the crisis, county officials have temporarily halted purchases of mortgaged-backed commercial paper and have commissioned a study of its other investments to assess the level of risk. The downgraded investment may result in losses in the millions of dollars to the county that has elected to purchase the investment from the pool.

.21 It is important for both entities participating in these pools and their auditors to gain a thorough understanding of the valuation methodology that the pool applies to its investments, the underlying risks involved with each investment type, and the likelihood that the value of the investments will be impaired.

Housing Downturn Effects

.22 Local governments across the country are beginning to feel the revenue shortfall effects from a slumping real estate market. Coupled with the effects of the subprime mortgage crisis, this economic downturn is likely to result in tough times ahead for cities and counties. Flattening or declining property assessments on which property taxes are based, as well as the mounting number of mortgage foreclosures, are reflecting poorly on local government revenue collections. In a report by the National League of Cities (NLC), local government budget officials surveyed indicated that the direct effects of the housing downturn could have a lag time of several years when it comes to their revenue. The report, based on responses from finance and budget officers in 359 cities, all with populations of 10,000 or more, found that 70.0 percent believed their cities were better able to meet fiscal needs in 2007 than in 2006; however, many were very pessimistic about the years ahead. Those surveyed stated that for the 2008 fiscal year, they were, on the average, predicting only a 0.4 percent increase in inflation-adjusted revenue, while expenditures were anticipated to increase by 3.5 percent, or a 3.1 percent budget deficit. To handle revenue shortfalls and budget deficits, cities and towns are looking to a number of alternatives, including increasing fees for services, raising property and sales taxes, and using rainy days funds. The NLC report entitled *City Fiscal Conditions in 2007* is available at www.nlc.org/ASSETS/6F3B16AE550F47D1B8C7CF7C48B1A454/07_FiscalSurveyBrief.pdf.

.23 The property tax revenue shortfall created by the housing issues discussed above could result in governments that are unable to meet financial obligations on bonds or unable to pay for the services that they are responsible to provide to residents. Some governments may find that filing for bankruptcy is the best option for them. Auditors should be alert to risks related to going concern issues and to events that occur subsequent to the balance sheet date and how these areas will affect the audit.

Retiree Health Care and Postemployment Benefits Other Than Pensions

.24 Retiree health care costs and other postemployment benefits other than pensions continue to be an economic issue of major concern for most state and local governments. In its recent report *Promises with a Price*, the Pew Charitable Trusts conservatively estimated that state governments will spend approximately $2.73 trillion on pensions, health care, and other postemployment benefits during the next 30 years, of which $381 billion is the price tag for retiree health care and other nonpension benefits. The report cites 8 states whose unfunded actuarial liability for other postemployment benefits other than pensions (OPEB) is greater than its unfunded actuarial liability for its pension plans. The reports indicate that in the state of California alone, annual state and local government retiree health care costs were $4 billion in 2006 and are expected to escalate to $10 billion in 2012 and $27 billion in 2019. With people living longer, the rising cost of health care, and few governments funding these costs as incurred through irrevocable trusts, the unfunded liabilities are likely to grow at an ever-increasing pace. The Pew report is available at www.pewcenteronthestates.org/uploadedfiles/Promises%20with%20a%20Price.pdf.

.25 As the required implementation dates for Governmental Accounting Standards Board (GASB) Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, have arrived for some and are approaching for others, the focus on OPEB, including retiree health benefits, for state and local government employees has been increasing. Because many governments previously have not measured or disclosed in their financial statements their obligations to pay OPEB costs, the media, the bond market, and state and local government legislative bodies are starting to focus on the potentially significant sum of those obligations, sometimes in the billions of dollars for an individual state. In addition, a government that does not manage its OPEB liability on a go-forward basis, especially the growth in its liability, could find itself explaining its OPEB and funding policies or lack of a funding policy to credit rating agencies when issuing bonded debt.

.26 Public employee unions and retirement benefit administrators across the country are concerned that a change from the pay-as-you-go accounting approach might lead to a reduction in benefits. Many predict significant changes in OPEB as governing bodies become better informed through actuarial or similar valuations about the amount of the obligations and the effects of not managing them. Some governments have formed task forces to help them identify solutions. Auditors might consider working with the actuarial firms retained by the auditee or, if necessary, retaining actuarial specialists to evaluate auditee valuations and might also be prepared to answer their auditees' questions about managing those obligations.

.27 Common solutions that have been discussed for managing the OPEB obligation and its growth include restricting new entrants into the plan, raising the employee cost share, lengthening the vesting period, restricting ad hoc benefit increases, and converting a defined benefit plan to a defined contribution plan. Another common solution is to begin to advance fund the obligation as normally is done with pension obligations, which is a long-term solution that will take years with a well-managed funding program to fully fund the accrued liability. Some governments may even consider discontinuing or reducing benefits for current and retired employees, although that may not be possible because of legal, contractual, or other restraints. Whichever solutions are chosen by the entity, they likely will be difficult to implement.

.28 A recent study and report by the GAO looked into both the current status of state and local government retiree benefit structures and the fiscal outlook for funding their future costs. The report noted that a heightened sense of concern has been raised questioning whether state and local governments offering such benefits will be able to continue to provide the current level of benefits to retirees in the future.

.29 State and local government employees make up approximately 12 percent of the nation's workforce and are generally provided retiree benefits in two components: pensions and retiree health care. The GAO report found that there were significant differences between how these two benefit components were structured, managed, and funded.

Differences Between Pension and Retiree Health Care Systems		
	Pensions	*Retiree Health Care*
How Structured	Mostly as a defined benefit based on a formula; once accrued, cannot be diminished	Varied sharing of premium costs between the government and retiree; benefit plans can change for current and future retirees
How Managed	As trusts, with board of trustees oversight	As operating expenses managed with other employee benefits
How Funded	Prefunded, with monies set aside and invested	Pay-as-you-go funded, with annual operating funds used as costs are required to be paid

.30 The GAO study results simulated the outlook for the state and local government sector as a whole, and concluded that

- estimated future pension costs (currently about 9 percent of employee pay) would require an increase in annual government contribution rates of less than 0.5 percent; and
- estimated future retiree health care costs (currently about 2 percent of employee pay) would more than double by the year 2050 if they continue to be funded on a pay-as-you-go basis.

.31 The GAO did recognize the sensitivity of its estimates to assumed rates of return and projected inflation rates; however, it also recognized that if rates of return were to fall below historical averages, the funding requirement could become even higher. The GAO report concluded that while state and local governments have strategies to manage future pension costs, similar strategies were not in place to manage the escalating costs of retiree health care. The GAO suggested that in future debates on retiree benefits, policy makers, voters, and beneficiaries will need to decide how to control costs, the appropriate level of benefits, and who should pay the costs.

.32 The entire GAO report is available from the GAO Web site as report no. GAO-07-1156 at www.gao.gov.

Tax Exempt Bonds Compliance Issues

Tax Exempt Debt Issues

.33 The current credit environment has affected the market for debt securities. While all debt securities may be affected, particular issues affect municipalities, states, cities, and other governments (such as redevelopment agencies, school districts, public universities, airports, and seaports) issuing tax exempt debt. Some examples of these tax exempt debt securities are auction rate securities (ARSs) and variable rate demand obligations (VRDOs).

.34 While each situation is different and should be evaluated based on its own specific facts and circumstances, the current situation may raise various accounting and auditing issues pertaining to tax exempt debt, including, but not limited to, the following:

- Bond restructurings
- Derivative and hedge accounting implications
- Potential violation of debt covenants

- Classification of the debt on the balance sheet as either a current or noncurrent liability
- Subsequent event disclosures
- Going concern issues

.35 For further information, refer to a nonauthoritative article that the AICPA has posted to its Web site, authored by an ad hoc group of AICPA members, *Tax-Exempt Bonds—Accounting and Auditing Considerations in the Current Environment*. The article can be accessed at www.aicpa.org/download/acctstd/ARS_article14.pdf.

GAO Report to Congress

.36 In February 2008, the GAO issued a report to the Committee on Finance of the U.S. Senate titled Tax-Exempt Status of Certain Bonds Merits Reconsideration, and Apparent Noncompliance with Issuance Cost Limitations Should Be Addressed (GAO-08-364).

.37 In the report, the GAO addresses the following areas of concern:

- Trends in the use of tax exempt bonds
- Questions regarding the appropriateness of certain types of facilities financed with tax exempt bonds
- Questions regarding the issuance costs paid from tax exempt bond proceeds as they can divert funds from the funded projects

.38 For federal tax purposes, municipal bonds are classified as either governmental bonds or private activity bonds. Tax exempt governmental and private activity bonds are used to finance a wide range of projects and activities, such as schools, fire stations, roads, airports, docks, golf courses, hotels, sports stadiums, and economic development. The Internal Revenue Code does not specifically define governmental bonds; rather, all municipal bonds that do not meet the criteria to be classified as private activity bonds are governmental bonds. If more than 10 percent of the governmental bonds' proceeds are used for private business purposes and secured by payments from property used for private business use, the bonds are classified as private activity bonds. Such private activity bonds can be taxable bonds. Private activity bonds that receive tax exempt status are considered *qualified private activity bonds*. Nonprofit organizations are generally the largest issuers of qualified private activity bonds. Although state and local governments and nonprofit organizations can use tax exempt bonds to subsidize activities of private entities, Congress has previously placed limitations on the use of funding for specific private activities, such as professional sports stadiums, hotels, and private golf courses.

.39 Generally, qualified private activity bonds are subject to various restrictions, including a 2 percent limitation on use of the proceeds to pay issuance costs. The GAO report found that a number of qualified private activity bond issues paid for issuance costs from the bond proceeds that exceeded these statutory limitations.

.40 Since 2002, the dollar amount of long-term tax exempt bonds issued annually has reached historically high levels. Congressional interest in the use of tax exempt bonds has heightened because of the large dollar amounts of bonds outstanding coupled with the large amounts of forgone federal tax revenues. The interest earned by investors who purchase tax exempt bonds is generally excluded from federal income taxes, which makes them very attractive and popular with investors; however, the federal revenue losses from this tax exemption amount to billions of dollars annually. Because the federal government does forgo these billions in tax revenues annually by excluding the bonds' interest from investors' federal gross income, Congress has become very interested in determining whether these bonds are being used for appropriate tax exempt purposes.

.41 The GAO, in its opening letter to Congress, made the following analysis:

The outstanding volume of state and local government tax exempt bond debt grew significantly from about $1.4 trillion in 2000 to over $2.1 trillion in 2006 in constant 2007 dollars. Because the tax exemption allows taxpayers to generally exclude the bond interest from their federal gross income, the federal government forgoes tax revenue. According to our analysis of the Department of the Treasury's estimates, forgone federal tax revenues were about $32 billion in 2000 and were projected to be about $37 billion in 2007.

.42 The GAO issued the following conclusions and recommendations to Congress and the IRS:

- State and local governments have broad discretion in deciding which activities and facilities to finance using tax exempt bonds. In particular, the broad discretion afforded to state and local governments allows them to use tax exempt governmental bonds to finance facilities and activities that cannot be financed with private activity bonds. Recently, the dollar amount of tax exempt governmental bonds reached peak levels as municipal governments issued bonds for a wide variety of purposes ranging from traditionally public facilities, such as schools, fire stations, and roads, to facilities that are essentially private in nature, such as sports stadiums. As Congress considers whether tax exempt governmental bonds should be used for professional sports stadiums that are generally privately used, it will also consider whether other facilities, including hotels and golf courses, that are privately used should continue to be financed with tax exempt governmental bonds.
- To better ensure that the IRS can routinely and cost effectively determine whether issuers of qualified private activity bonds are complying with the statutory limits on using bond proceeds for issuance costs, the GAO recommended that the Commissioner of Internal Revenue take the following two actions based on the GAO report to Congress:
    - — Clarify the IRS's forms and instructions for reporting issuance costs paid from bond proceeds to require that bond issuers clearly designate on the form instances when bond proceeds were not used to pay issuance costs.
    - — Develop cost-effective methods to address apparent noncompliance with the statutory limits on using bond proceeds for issuance costs in such a manner that it would not preclude the IRS from examining the bonds for more substantive compliance issues in the future.

.43 To review this GAO report in full length, please refer to report no. GAO-08-364 at www.gao.gov.

IRS Interest in Tax Exempt Bonds Compliance

.44 Within the past year, the IRS has stepped up its efforts to monitor the tax exempt bond financing market. Most recently, the IRS has conducted post-issuance compliance for bonds issued by nonprofit organizations and has expressed the interest in expanding the postissuance compliance monitoring to state and local governments. The IRS has indicated that it will be monitoring the governmental bonds area in an effort to better learn what issuers are doing, draw some conclusions, and determine whether more bond issuance guidance and education are needed.

Legislative and Regulatory Developments

Securities and Exchange Commission Developments

Recent Accounting and Disclosure Initiatives

.45 The municipal securities market is a top priority for the Securities and Exchange Commission (SEC). In July 2007, SEC Chairman Christopher Cox gave a town hall speech on "Integrity in the Municipal Market," and also delivered a white paper to Congress calling for improvements in accounting and disclosure in the municipal securities market. The white paper notes that the SEC staff believes that Congress should consider revisions to the current disclosure and accounting requirements for municipal issuers to provide investors and other participants in the municipal securities market with information and protections comparable to those available in many other U.S. capital markets, while giving deference where appropriate to the special disclosure and accounting aspects of municipal issuers. The SEC staff identified a variety of steps that should be taken that would improve for investors the extent, quality, and availability of municipal issuer information. These steps include the following:

- Making available to investors, without charge, municipal issuer offering documents and periodic reports on a timely basis through an easily accessible venue, such as a system similar to the EDGAR database
- Mandating municipal issuer use of GAGAS
- Encouraging and supporting timely development of high-quality governmental accounting standards by, for example, providing an independent funding mechanism for GASB and requiring or permitting SEC oversight of GASB, as is now provided by Sections 108–109 of the Sarbanes-Oxley Act for the Financial Accounting Standards Board (FASB)

.46 The SEC feels it is important that the independence of accounting standard setters and the perception of their independence by investors be maintained, and that universal use of consistent generally accepted accounting principles (GAAP) by all issuers of municipal securities promotes transparency, accuracy, consistency, and comparability of the financial statements of state and local governments to investors and other participants in the municipal market, as well as to taxpayers and other traditional governmental constituencies.

.47 The SEC staff is now taking a comprehensive look at the disclosure requirements for the municipal market. They plan to consider a wide array of options to improve the disclosure and accounting rules for municipal bond offerings as they analyze whether the current municipal regulatory structure is achieving its objectives as initially contemplated and as markets have evolved. On March 31, 2008, the Municipal Securities Rulemaking Board (MSRB) launched a pilot version of its Electronic Municipal Market Access (EMMA) system, a free, centralized online portal that initially will provide free access to official statements and advance refunding documents received by the MSRB under its Rule G-36. The MSRB is currently developing a proposal to establish an expanded permanent public access system.

Auditor Responsibility for Disclosure

.48 A number of SEC enforcement actions have suggested a need for improvement in the quality of accounting and disclosures made by state and local governments. Auditors are subject to the antifraud provisions of the federal securities laws and may be held liable for material misstatements or omissions in documents containing audited financial statements, such as preliminary or final official statements with which they are associated. Disclosures that are unclear or difficult to understand may increase an auditor's exposure to liability. When associated with the official statements, auditors should remember their responsibilities under AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1). As described in chapter 16 of the AICPA Audit and Accounting Guide *State and Local Governments*, the following are situations in which the auditor becomes associated with the official statement:

- Assisting in preparing the financial information included in the official statement
- Reviewing a draft of the official statement at the government's request
- Signing (either manually or electronically) the independent auditor's report for inclusion in a specific official statement[1]
- Providing written agreement (for example, through a consent letter or signed authorization form) for the use of the independent auditor's report in a specific official statement

[1] This situation involves an original manual or electronic signature on the auditor's report, not a reproduction of an auditor's report that was manually or electronically signed. For example, the underwriter or bond counsel may require a copy of the auditor's report with an original manual or electronic signature to file with the official closing documents for the offering.

- Providing a revised independent auditor's report for inclusion in a specific official statement
- Issuing a comfort letter, the letter described in AU section 634, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*, vol. 1), paragraph .09, or an attestation engagement report in lieu of a comfort or similar letter on information included in the official statement
- Issuing a report on an attestation engagement relating to the debt offering

.49 If the auditor is associated with an official statement, the guidance in AU section 550 paragraphs .04–.06 provides that the auditor has no obligation to perform any procedures to corroborate other information[2] 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. AU section 550 provides guidance if the auditor concludes there is a material inconsistency or a material misstatement of fact that is not a material inconsistency. This responsibility includes reading the other information and considering whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. Accordingly, when audited financial statements are included in an official statement, and the auditors are associated with the official statement, auditors should take a "big picture" approach and consider whether any other information in that official statement is materially inconsistent with the audited financial statements.

Consents

.50 In some cases, issuers of municipal securities include audit opinions and audited financial information in disclosure documents without obtaining the consent of the auditor. Because consents must be obtained from auditors in the corporate market before an audit opinion may be included in an offering document, investors in municipal securities may not be aware that this is not always the case in a municipal offering. Auditors may want to consider working with their governmental clients to advise them in making appropriate disclosures to investors in situations where governmental clients intend to use the audit opinion or audited financial information without the auditor's consent. Chapter 16 of the AICPA Audit and Accounting Guide *State and Local Governments* provides additional guidance on auditor association with municipal securities filings.

Plain English

.51 In 1998, the SEC adopted rules requiring all securities registrants to use *plain English* in writing prospectuses and in the organization, language, and design of the front parts of prospectuses. These plain English rules do not apply to the municipal market, but the SEC encourages their voluntary use. Municipal disclosures often abound in legalistic or overly complex presentations that make the substance of the disclosure difficult to understand. Vague boilerplate explanations are readily subject to differing interpretations. The SEC encourages those involved with municipal security issuances to remember that most investors who read official statements are not accountants and may have limited accounting backgrounds.

Stale Disclosure

.52 Stale and incomplete accounting information is at the core of many of the cases the SEC has brought against municipal market participants. Many of the auditors' reports on the financial statements used in primary offering disclosure documents and in continuing disclosure filings made pursuant to SEC Rule 15c2-12, *Municipal Securities Disclosure*, are many months old at the time of the offering, raising the risk of an antifraud violation if there have been material changes since the audit was completed. Efficient markets require timely and reliable information to function properly. As a client service, auditors may work with their governmental auditees to try to improve the timeliness of their audited financial statements. Auditors

[2] *Other information* is a term used in AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), and is defined therein as information in addition to audited financial statements and the independent auditor's report thereon.

should also remember their obligations under AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), regarding subsequent events, including in circumstances where a governmental auditee requests the auditor's consent to the inclusion of its audit opinions in disclosure documents.

IRS Developments

.53 IRS activities may affect the financial statement audits of state and local government auditees. Noncompliance with federal tax requirements could have a direct and material effect on the determination of financial statement amounts. In addition, changes in U.S. Department of the Treasury and IRS regulations might result in changes in a government's activities.

.54 There is a wealth of information on the IRS Web site (www.irs.gov). The site provides separate pages for state and local governments (www.irs.gov/govts), Indian tribal governments (www.irs.gov/tribes), tax exempt bonds (www.irs.gov/taxexemptbond/index.html), and employee retirement plans (www.irs.gov/ep). These pages provide the opportunity to access and subscribe to various newsletters or e-mail alerts, such as the IRS Office of Federal, State, and Local Governments' (FSLG) *FSLG Newsletter* and the *Tax Exempt Bond Community Update*, which will keep auditors updated about relevant IRS activities.

Tax Exempt Debt Auction Failures and IRS Notice 2008-27

.55 In response to a growing number of auction and remarketing failures regarding variable rate tax exempt debt, the IRS published Notice 2008-27 to address requests for relief from *reissuance* treatment of restructurings of tax exempt obligations by issuers seeking to replace, wrap, or remove damaged credit facilities and convert tender options (variable rate remarketed) bonds to more marketable interest modes of debt.

.56 The effect of avoiding the reissuance classification is that the debt restructuring could avoid certain tax consequences and requirements associated with typical refundings, including accelerated rebate payments, truncated yield calculation periods, and other tax requirements.

.57 Generally, the notice clears the way for most debt restructurings that are made to convert tax exempt debt from a short-term interest mode to a long-term interest mode to avoid interest rate spikes and other negative consequences from auction or remarketing failures as a debt restructuring that will not be considered a reissuance for federal tax purposes. The notice also provides relief to certain tax exempt bonds undergoing a change in security or credit enhancement.

.58 Notice 2008-27 may be found in its entirety at the IRS Web site for tax exempt bonds at www.irs.gov/taxexemptbond/index.html.

IRS Focus on Tax Compliance

.59 The FSLG has indicated that it will focus on tax compliance issues in 2008 in regards to state and local governments after completing an examination of community colleges and initiating another examination on housing authorities. FSLG's customer base, with assets of more than $16 trillion employs more than 23 million people or approximately 20 percent of the American workforce, and annually pays wages of more than $775 billion and employment taxes of more than $200 billion. Attention will be paid to abusive tax avoidance transactions, such as certain health reimbursement arrangements.

Sales Tax on Internet Sales

.60 For years, this alert has discussed the ongoing debate about the taxation of Internet sales. As discussed in the 2006 and 2007 alerts, the Internet Tax Nondiscrimination Act (Public Law [P.L.] 108-357, December 3, 2004) bans new Internet access taxes and new, multiple, and discriminatory taxes on electronic commerce (e-commerce; that is, Internet sales) until November 1, 2007. On October 31, 2007, President Bush signed a bill that provided an extension of the moratorium for another seven years. P.L. 110-108, the Internet

Tax Freedom Act Amendments Act of 2007, extended the moratorium to November 1, 2014, makes some changes to the grandfather clause in the original legislation that protects state and local taxes imposed on Internet access prior to 1998, and clarifies the definition of *Internet access*. Some legislators support a permanent ban and, in January 2007, introduced a resolution entitled Permanent Internet Tax Freedom Act (H.R. 743).

Audit and Attestation Issues and Developments

Government Auditing Standards Developments

July 2007 Revisions to Government Auditing Standards

.61 In July 2007, the GAO issued the 2007 revision to *Government Auditing Standards* (GAO-07-731G). The revisions supersede the 2003 revision, are wide-ranging, and will affect your *Government Auditing Standards* financial statement audits and attestation engagements for periods beginning on or after January 1, 2008 and for performance audits beginning on or after January 1, 2008. Early implementation is encouraged. The printed version of the 2007 revision is available and can be ordered from information provided on GAO's Yellow Book Web page (www.gao.gov/govaud/ybk01.htm).

.62 Certain standards issued by the AICPA incorporated by reference into the 2007 revision have earlier effective dates (see the "Summary of Recent Auditing and Attestation Pronouncements and Related Guidance" section of this alert). The GAO has indicated that for financial statement audits conducted under *Government Auditing Standards*, the effective dates of those AICPA standards will apply.

.63 Additionally, the GAO states that the 2007 revision should be used in conjunction with the following guidance documents, which are also available at www.gao.gov/govaud/ybk01.htm:

- Government Auditing Standards: *Answers to Independence Questions* (GAO-02-870G, July 2002)
- Government Auditing Standards: *Guidance on GAGAS Requirements for Continuing Professional Education* (GAO-05-568G, April 2005)

> **Help Desk—**The 2007 revision of *Government Auditing Standards* is available for download at no charge at www.gao.gov/govaud/ybk01.htm. That site also has a summary of major changes and a slide presentation on the revision (GAO-07-162G). Another document of interest describes the technical changes made by the GAO from the January 2007 revision (which had been issued by the GAO in advance of it finalizing the quality control and peer review sections in chapter 3) to the July 2007 revision. It can be found at www.gao.gov/govaud/ltc0707.pdf.

Government Auditing Standards: Implementation Tool

.64 The GAO has issued a guidance document, Government Auditing Standards: Implementation Tool—Professional Requirements Tool for Use in Implementing Requirements Identified by "Must" and "Should" in the July 2007 Revision of Government Auditing Standards. The professional requirements tool lists the requirements for audit organizations and auditors included in the 2007 revision of Government Auditing Standards.

.65 The tool is divided into four sections. The general requirements section contains entity-wide requirements for the audit organization and is intended for use in addition to the specific sections for financial audits, attestation engagements, and performance audits, which contain engagement-specific requirements for the auditors conducting the engagement. Audit organizations and auditors should also refer to the complete text of the 2007 revision of *Government Auditing Standards* to understand the context for those requirements along with related guidance.

.66 The tool was prepared by the GAO's *Government Auditing Standards* staff to facilitate audit organizations' and auditors' implementation of the standards and to assist auditors with documenting compliance with *Government Auditing Standards*, and does not represent additional standards or requirements.

.67 The tool is available in an electronic PDF format at www.gao.gov/new.items/d08210g.pdf (GAO-08-210G, December 2007). The tool should help auditors quickly identify standards and requirements, and make decisions about those standards applicable to their audits.

Results of Federal Study on Single Audit Quality

.68 The long-awaited federal study on the quality of audits performed under OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (also referred to as single audits) was issued on June 22, 2007. This section presents a summary of findings, a listing of some deficiencies noted, and the report recommendations. The section also highlights the AICPA and its Governmental Audit Quality Center's (GAQC) next steps to responding to the report.

Summary of Findings

.69 The issues and deficiencies identified in each QCR were compiled, and each engagement was then classified into one of three groupings. The groupings are defined as follows:

Acceptable. No deficiencies were noted, or one or two insignificant deficiencies were noted. In some cases, the acceptable audits had deficiencies with applicable auditing criteria noted, which did not require corrective action, but should be corrected going forward.

Limited Reliability. Significant deficiencies with applicable auditing criteria were noted and require corrective action to afford unquestioned reliance upon the entire audit.

Unacceptable. Deficiencies were so serious that the auditor's opinion on at least one major program cannot be relied upon, or a material reporting error was noted requiring that the report be reissued in order to be relied upon by users, or both.

.70 The President's Council on Integrity and Efficiency (PCIE) report clearly shows that improvements are needed in many areas. The tables that follow summarize the overall results and results by stratum. In addition to providing results by the number of audits reviewed, the OIGs also analyzed the results in relation to the dollar amounts of federal awards reported in the audits reviewed. Results in relation to dollar amounts reported in the audits reviewed show a much higher percentage of acceptability. The following tables show the results for both strata combined and then the results of Stratum I and Stratum II individually.[3]

TOTAL SAMPLE (STRATA I and II)				
	Acceptable	*Limited Reliability*	*Unacceptable*	*Total*
Sampled Audits	115	30	63	208
Percent of Audits	49%	16%	35%	100%
Percent of Federal Dollars	93%	2%	5%	100%
STRATUM I (>$50 Million in Federal Expenditures)				
	Acceptable	*Limited Reliability*	*Unacceptable*	*Total*

[3] The report indicates the confidence parameter was 90 percent, and the precision parameters ranged between plus or minus 2.1 percentage points and 7.9 percentage points.

Sampled Audits	61	12	23	96
Percent of Audits	64%	12%	24%	100%
Percent of Federal Dollars	93%	2%	5%	100%
STRATUM II ($500 Thousand–$50 Million in Federal Expenditures)				
	Acceptable	*Limited Reliability*	*Unacceptable*	*Total*
Sampled Audits	54	18	40	112
Percent of Audits	48%	16%	36%	100%
Percent of Federal Dollars	56%	10%	34%	100%

Deficiencies Identified

.71 The PCIE report goes into detail regarding the deficiencies noted on the audits reviewed. The following presents a brief summary of deficiencies identified:

- Misreporting of audit coverage of major federal programs
- Unreported audit findings
- Compliance testing not documented as performed or not applicable
- Deficiencies in understanding and testing of internal control over compliance
- Deficiencies in risk assessments as part of major program determination
- Missing audit finding information
- Deficiencies in presentation and auditing of the Schedule of Expenditures of Federal Awards
- Management representations related to federal awards missing or misdated
- Consideration of audit materiality at the major federal program level not documented
- Other kinds of deficiencies (described in appendix A of the report)

PCIE Report Recommendations

.72 The PCIE report proposes a three-pronged approach for reducing the deficiencies noted and to improve the quality of single audits. The recommendations in the report are directed to various organizations, including the OMB and other federal agencies, the AICPA, and other single audit stakeholders. A summary of the recommendations is as follows:

- Revise and improve single audit criteria, standards, and guidance to address deficiencies noted in the report. Specific recommendations are described throughout part II and the "Other Matters" sections of the PCIE report and include recommendations for revisions to Circular A-133 and, in some cases, additions or clarifications to AICPA auditing standards and the AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits*.
- Establish minimum requirements for completing comprehensive single audit training as a prerequisite for conducting such audits (the report suggests at least 16–24 hours) and, thereafter, require single audit update training for continued performance of single audits.
- Review and enhance processes to address unacceptable audits and not meeting established training and continuing professional education (CPE) requirements. This includes (*a*) reviewing the process

of suspension and debarment; (*b*) identifying ways that the AICPA and state boards of accountancy can further the quality of single audits and address due professional care issues; and (*c*) identifying, reviewing, and evaluating the potential effectiveness of other ways to address unacceptable audits (these other ways could include sanctions to be applied to auditors, fines, or both).

Next Steps

.73 The AICPA shares the commitment of the federal agencies involved in the project to improving the quality of single audits. Many of the audits reviewed were performed 4–5 years ago, and the AICPA is hopeful that many endeavors over the last several years (for example, the launch of the GAQC) have already begun to address some of the issues raised in the PCIE report.

.74 However, auditors should take this report very seriously and read the PCIE report in its entirety to determine if the audit quality deficiencies cited in the report may affect the planning of your future engagements or your current audit methodologies and documentation practices.

.75 The AICPA and the GAQC Executive Committee and GAQC staff have established several task forces and are working closely with the federal government to address the PCIE report recommendations. During the course of the next year, auditors should watch the GAQC Web site at www.aicpa.org/GAQC for updates on initiatives undertaken by the AICPA and others in response to the PCIE report.

> **Help Desk—**To access the PCIE report go to the following Web site: www.ignet.gov/pande/audit/NatSamProjRptFINAL2.pdf.

AICPA Audit Committee Toolkit for Government Entities

.76 Taxpayers and citizens of governmental entities expect a government to be publicly accountable for the services it provides and for how it utilizes its resources to provide those services. An audit committee has the opportunity to assist the governing body with fiscal accountability demonstrated through strong internal controls, budgetary and other legal compliance, accurate and timely financial reporting, sound business practices, and a culture of strong moral and ethical behavior. More specifically, an audit committee with a government organization can help the government achieve the following:

- Improve financial practices and reporting. An audit committee can periodically meet with the government's chief executive and financial officers to review, monitor, and direct activities and results related to the government's maintenance of internal controls and preparation of financial reports.
- Enhance the internal audit function. When an internal audit team reports directly to the audit committee, the internal audit team can provide information to the audit committee about whether the government is meeting its financial and compliance responsibilities, and recommend changes in practices and internal controls when necessary.
- Enhance the external audit function. An audit committee can meet with the external auditors to get independent observations about management's efforts to maintain strong internal controls, appropriate financial reporting, and sound business practices.

.77 For governments interested in establishing or enhancing an audit committee, the AICPA *Audit Committee Toolkit: Government Organizations* (toolkit) provides valuable information and tools that will help a governing body and its officials create an effective audit committee function to help improve fiscal accountability.

.78 These tools inform and educate audit committees about changes in government reporting standards and the government environment as a whole. For governments who already have an audit committee, the toolkit may improve the efficiency and effectiveness of the audit committee. In either situation, the toolkit's easy-to-use set of checklists, questionnaires, and other useful information can make the audit committee's job easier to accomplish. The goal of the toolkit is to assist government audit committees in taking a much greater role in providing information to and assisting the governing body with meeting their fiduciary responsibilities. The audit committee tools are available for download from Audit Committee Effectiveness Center of the AICPA Web site at www.aicpa.org/Audcommctr/toolkitsgovt/homepage.htm.

Other Governmental Audit Issues and Developments

Structured Investment Vehicles

.79 Many state and local governments have found themselves invested in structured investment vehicles (SIVs) without a sufficient understanding of their function and risks. A SIV is a fund that borrows money by issuing short-term securities at low interest and then lends that money by buying long-term securities at higher interest, making a profit for investors from the difference. A SIV is a type of relatively large structured credit product and invests in a range of asset-backed securities, as well as some financial corporate bonds. A SIV has an open-ended structure in that it plans to stay in business indefinitely by buying new assets as the old ones mature, and the SIV generally exchanges investments without providing investors transparency.

.80 The risk that arises from the transaction is twofold. First, the solvency of the SIV may be at risk if the value of the long-term security that the SIV has bought falls below that of the short-term securities that the SIV has sold. Second, there is liquidity risk, as the SIV borrows short term and invests long term; that is, pay-outs become due before the pay-ins are collected. Unless a governmental borrower can refinance short-term at favorable rates, it may be forced to sell the asset into a depressed market.

.81 The subprime mortgage crisis has caused a widespread liquidity crunch in the markets. Investors have become reluctant to invest as the crisis spreads. A number of SIVs have fallen victim to the lack of liquidity, while others received support from a sponsoring bank.

.82 Auditors of state and local government-holding investments in SIVs should obtain a thorough understanding of the investment vehicle and place a particular audit focus on the risks associated with the investment (collateral). Because of the complexity of these investment instruments, auditors should give due consideration to involving specialists in the audit engagement to assist in this evaluation.

Pensions, OPEB, and the Use of Specialists

.83 Upon the effective dates of GASB Statement No. 43; No. 45; and No. 50, *Pension Disclosures—An Amendment of GASB Statements No. 25 and No. 27*, defined benefit OPEB plans, defined benefit pension plans, and certain government employers are required to disclose, among other things, information about the funded status and funding progress of the plans as of the most recent actuarial valuation date in the notes to the financial statements. Such information includes, but is not limited to, the actuarial valuation date, actuarial assumptions, actuarial value of assets, the actuarial accrued liability, the total unfunded actuarial accrued liability, and the annual covered payroll. Most of these governments will use the services of an actuary in the valuation of the OPEB plan and determination of annual required contributions and annual OPEB costs and liabilities. Prior to these new standards, the funded status and funding progress of defined benefit pension plans was reported solely in required supplementary information (RSI). Under professional standards, the auditor has a greater responsibility for information disclosed in the notes to the financial statements than for information reported in RSI. Because auditors may not have actuarial knowledge, they may rely on information provided by plan actuaries. As a result, AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), will have particular importance to the auditor of state and local government financial statements when such government provides pensions and OPEBs and uses actuarial services for determination of financial statement amounts and disclosures. Paragraph .12 of AU section 336 states that, while determining the appropriateness and reasonableness of the methods and assumptions used and their application is the responsibility of the actuary, the auditor should (*a*) obtain an understanding of the methods and assumptions used by the specialist, (*b*) make appropriate tests of data (such as census data) provided to the specialist, and (*c*) evaluate whether the specialist's findings support the related assertions in the financial statements.

.84 The auditor might consider it necessary to retain a specialist to assist in evaluating the work of the plan actuary.

.85 Some example procedures for the auditor's consideration in meeting the requirements of paragraph .12 of AU section 336 regarding the entity's use of an actuary should include the following:

- Obtaining an understanding of the actuary's objectives, scope of work, actuarial methods, actuarial assumptions, and source and calculation methodology of health care cost trends within the acceptable parameters of the GASB statements
- Making appropriate tests of data provided to the actuary by considering the reliability and completeness of the plan census data and source of discount rates used
- Evaluating whether the actuary's findings support the related assertions in the financial statements by understanding what benefits are included in the substantive plan, the policy for contributions, and how plan investments are valued

Credit Markets and Insurance

.86 The crisis in the credit markets has claimed a number of victims including municipal bond insurers. Early in 2008, the credit ratings of some bond insurers were either downgraded or put on review for possible downgrade because of concerns over exposure to collateralized debt obligation backed by subprime and residential mortgages.

.87 In addition to concerns over the impact of this crisis on typical insured municipal bonds, especially those that require remarketing, auditors should also be aware that certain lease/leaseback arrangements typically contain insurance provisions that can result in lessee financial consequences when insurance ratings are downgraded or there is an absence of insurance. Further, the government entity could be required to provide appropriate collateral and often the original asset is no longer sufficient to meet the collateral needs. When these circumstances arise, the auditor should consider and evaluate the liability as well as disclosures surrounding the potential for deterioration of the insurer's rating and the condition of the collateral.

Component Units

.88 Questions regarding the appropriate reporting treatment for component units pursuant to GASB Statement No. 14, *The Financial Reporting Entity*, and No. 39, *Determining Whether Certain Organizations Are Component Units—an amendment of GASB Statement No. 14*, continue to be a leading area of inquiry for GASB staff and the GAQC. Auditors should consider annually revisiting and reevaluating component unit treatment within the reporting entity's financial statements, especially in light of potential amendments or other changes to bylaws, trust indentures, or legal arrangements between separate legal entities.

Pollution Remediation

.89 GASB Statement No. 49, *Accounting and Reporting for Pollution Remediation Obligations*, addresses accounting and financial reporting standards for pollution remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and cleanups. It is effective for financial statements for periods beginning after December 15, 2007, with measurement of pollution remediation liabilities required as of the beginning of the period so that the beginning balance of net assets can be restated. Of particular concern to auditors of state and local government financial statements are the assertions of existence, completeness, and valuation. Because of the difficulty in obtaining sufficient legal letter representations regarding these potential obligations, the auditor should generally consider the existence, completeness, and valuations assertions as possessing a relatively high inherent risk of misstatement when performing risk assessment procedures. See additional discussion of GASB Statement No. 49 in the "Accounting Issues and Developments" section of this alert.

Summary of Recent Auditing and Attestation Pronouncements and Related Guidance

.90 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Auditing Standards (SAS) No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard replaces SAS No. 61, *Communication With Audit Committees*. The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards*, to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120). • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks. • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report.* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report.
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	See the "AICPA Risk Assessment Standards" section in this alert.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 9325 par. .01–.04) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.
Interpretation No. 1, "Use of Electronic Confirmations" of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 9330 par. .01–.06) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) sections 8200.05–.16 (AICPA, *Technical Practice Aids*) Issue Dates: April and May 2008 (Nonauthoritative)	These questions and answers in TIS section 8200, *Internal Control*, were developed in response to common questions received from members regarding the implementation of SAS Nos. 104–111, referred to as the risk assessment standards.
TIS section 9120.08, "Part of an Audit Performed in Accordance With International Standards on Auditing" (AICPA, *Technical Practice Aids*) Issue Date: April 2008 (Nonauthoritative)	This question and answer discusses the implications to the principal auditor's report when part of an audit is conducted by other independent auditors in accordance with International Standards on Auditing or another country's auditing standards.

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.
TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.
AICPA Professional Issues Task Force Practice Alert 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This practice aid is a response to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.

The Auditor's Communication With Those Charged With Governance

.91 In December 2006, the Auditing Standards Board (ASB) issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees*. This SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and became effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to entities that either have an audit committee or have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers including state and local governments, regardless of size, ownership, or organizational structure.

.92 SAS No. 114 provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires that significant matters communicated with those charged with governance be documented.

Identifying Those Charged With Governance

.93 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those 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.

.94 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and other organizational characteristics. In addition, for state and local governments, auditor judgment may be required to determine the appropriate parties or individuals with whom to communicate when the financial reporting entity is comprised of a primary government and component units with different governing bodies and governance structures.

.95 Because there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some financial reporting entities that comprise the primary government and discretely presented component units. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Issues Regarding Two-Way Communications

.96 SAS No. 114 paragraphs 7–8 discuss the role of communication between the auditor and those charged with governance. Paragraph 8 indicates that SAS No. 114 focuses primarily on communications "from the auditor to those charged with governance," but also states that effective two-way communication is important.

.97 The GAQC staff has received a number of inquiries regarding the appropriate method to establish two-way communication. Auditors should consider the following:

- The objectives of the communication are to ensure that those charged with governance understand the auditor's responsibilities, to obtain from those charged with governance information relevant to the audit, and to provide those charged with governance information relevant to their responsibilities.
- The standard has no authority to require the client or those charged with governance to communicate with the auditor. It merely emphasizes the benefits of two-way communication and provides guidance for such communications.
- If the client and those charged with governance are unwilling to engage in requested two-way dialogue, this may be an indication of an unsatisfactory control environment and could be considered as a significant deficiency or material weakness to be communicated pursuant to SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

Communicating Internal Control Related Matters Identified in an Audit

.98 The ASB issued SAS No. 112, which became effective for audits of financial statements for periods ending on or after December 15, 2006. SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. This SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion). Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. When SAS No. 112 was issued, the terms *significant deficiencies* and *material weaknesses* were consistent with Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. However, with the adoption of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), the PCAOB redefined these terms, which now differ from SAS No. 112.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.
- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, and identifies indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.
- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.
- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.
- Contains illustrative written communications to management and those charged with governance.

Discussions With Management and Others

.99 The requirements of SAS No. 112 have changed perceptions regarding the auditor's role in the client's internal control in some circumstances. Auditors may have to continue to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm, other than the auditor, that does not provide attest services for the client can be part of a client's internal control. This may continue to raise questions regarding the role of outsourcing in achieving management's internal control objectives.

.100 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of material weaknesses. Another reason is that auditors have to include in written communication significant deficiencies and material weaknesses that were identified and communicated in previous years until these deficiencies have been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.101 Auditors may also need to hold discussions with management and those charged with governance who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented or detected and corrected, by the client.

Issues for Audits of Smaller Entities

.102 An issue that has caused concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. A strong indication that a material weakness in internal control exists is that a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, or detecting and correcting, material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, because doing so would impair independence.[4] How an auditor responds to a client's internal control deficiency, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control deficiency. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control deficiency by assisting in drafting the financial statements does not change that control deficiency.

.103 The requirements of SAS No. 112 will continue to introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing. Auditors should watch the GAQC Web site at www.aicpa.org/gaqc for updates on developments in this area and how those developments will affect state and local government audits.

.104 The AICPA published Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control deficiencies would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Audits Performed Under Government Auditing Standards

.105 Because many state and local government financial statement audits are also performed under *Government Auditing Standards*, auditors should be aware that the required *Government Auditing Standards* reporting is also affected by the issuance of SAS No. 112. As noted by the GAO upon issuance of the 2007 revision to the Yellow Book (see further discussion in the section titled "*Government Auditing Standards* Developments"), auditors should adopt the terminology and definitions in SAS No. 112 when reporting on internal control deficiencies. Updated Yellow Book report illustrations have been posted to the GAQC Web site at http://gaqc.aicpa.org/Resources/Illustrative+Auditors+Reports. In the event your auditees are also subject to OMB Circular A-133, the GAQC Web site also includes updated internal control reporting for those audits.

AICPA Risk Assessment Standards

.106 The eight SASs referred to as the risk assessment standards (SAS Nos. 104–111) became effective for audits of financial statements for periods beginning on or after December 15, 2006, (earlier application was permitted), which means they are effective for 2007 calendar year audits. Although the SASs include many of the underlying concepts and detailed performance requirements contained in the standards they amend or supersede, they do create significant new requirements for the auditor. The risk assessment standards

[4] See Ethics Ruling 101-3, "Performance of nonattest services," of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risks of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between the risks, controls, audit procedures, and conclusions.

Key Provisions of the Risk Assessment Standards

.107 Whether due to error or fraud, the risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks that may lead to a material misstatement in the client's financial statements and any mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations of the Treadway Commission's framework at www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs should have already been completed and has likely resulted in significant changes to firm audit methodologies and personnel training.

Unique Aspects of Applying the Risk Assessment Standards for State and Local Government Audits

.108 As discussed in more detail in chapter 4 of the AICPA Audit and Accounting Guide *State and Local Governments*, in considering risks of material misstatement at the overall financial statement level (the financial statements taken as a whole), in a governmental audit, the term *taken as a whole* means considering each *opinion unit* separately. Opinion units could include: governmental activities; business-type activities; aggregate discretely presented component units, each major governmental and enterprise fund, and the remaining fund information—nonmajor governmental and enterprise funds, internal service funds, and fiduciary funds. In addition, risks of a pervasive nature often relate to the government entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, disclosure level, or opinion unit. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control.

Risk Assessment Standards Technical Practice Aids

.109 To assist auditors in implementing the risk assessment standards in their audits, the AICPA has issued a series of nonauthoritative Technical Practice Aid (TPA) Technical Questions and Answers (TIS) relating to internal control. TIS sections 8200.05–.16 (AICPA, *Technical Practice Aids*), have been developed in response to common questions received from auditors. Topics include testing the operating effectiveness of internal control, obtaining an understanding of the control environment, use of walkthroughs, documenting internal control, and several others.

Companion Audit Guide

.110 In December 2006, the AICPA published Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors further understand the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Accounting Issues and Developments

GASB Accounting Standards Upcoming Implementation Dates

.111 A number of GASB pronouncements issued prior to 2007 have provisions with effective dates for fiscal periods ending in 2008 and 2009. These pronouncements and applicable implementation provisions are highlighted as follows.

GASB Statement No. 27, Accounting for Pensions by State and Local Governmental Employers—Reduction in Maximum Amortization Period for Unfunded Actuarial Liability

.112 This statement established standards for the measurement, recognition, and display of pension expenditures and related liabilities, assets, note disclosures, and RSI in the financial statements of state and local government employers. Paragraph 10.f.1 of GASB Statement No. 27 provided that, for purposes of calculating the annual required contribution, the maximum acceptable amortization period for the total unfunded actuarial liability (UAL) was 40 years for a term of not more than 10 years from the effective date of GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*. After that 10-year term, the maximum acceptable amortization period is 30 years.

.113 While GASB Statement No. 27 became effective for periods beginning after June 15, 1997, its companion statement GASB Statement No. 25 became effective for periods beginning after June 15, 1996. Therefore, the maximum UAL amortization period of 30 years is effective for periods beginning after June 15, 2006.

GASB Statement No. 34, Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments—Retroactive General Infrastructure Reporting—Phase 2 Governments

.114 Included among the many provisions of GASB Statement No. 34 was the requirement for the reporting of general infrastructure assets. Paragraph 148 of GASB Statement No. 34 required prospective reporting of general infrastructure assets in the statement of net assets based on the phased-in dates as noted in the following:

- Phase 1 governments—with total annual revenues of $100 million or more—should apply the requirements of this statement in financial statements for periods beginning after June 15, 2001.
- Phase 2 governments—with total annual revenues of $10 million or more, but less than $100 million—should apply the requirements of this statement in financial statements for periods beginning after June 15, 2002.
- Phase 3 governments—with total annual revenues of less than $10 million—should apply the requirements of this statement in financial statements for periods beginning after June 15, 2003.

.115 However, retroactive reporting of all major general infrastructure assets was only encouraged at the above dates. GASB indicated that, effective at later dates, Phase 1 and 2 governments would be required to retroactively report all major general infrastructure assets, while Phase 3 governments were encouraged but not required to report major general infrastructure assets retroactively.

.116 Phase 1 governments, as described in the preceding summary, were required to retroactively report all major general infrastructure assets for fiscal years beginning after June 15, 2005. Phase 2 governments will now be required to retroactively report all major general infrastructure assets for fiscal years beginning after June 15, 2006.

.117 As we discussed in previous alerts, we have been asked whether that retroactive reporting of infrastructure is a change in accounting principle that requires the auditor to include an explanatory paragraph in the auditor's report on the financial statements in the year of retroactive reporting. The answer is no because the change in accounting principle occurred in the year that the entity adopted GASB Statement No. 34. Because the retroactive reporting would result in a restatement of beginning net assets, the matter would likely be disclosed in the notes to the financial statements. The auditor should consider whether appropriate disclosure has been made in the year of retroactive reporting. Further, while the retroactive reporting is not a change in accounting principle, the auditor may add an explanatory paragraph to the auditor's report to emphasize the matter as provided in AU section 508 paragraph .19, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1).

GASB Statement No. 43, Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans

.118 This statement establishes standardized financial reporting standards for OPEB plans. The standards in this statement apply for OPEB trust funds included in the financial statements of plan employers, as well as for the outside financial statements of OPEB plans or the employee retirement systems, or other third parties that oversee them. Requirements for reporting of OPEB funds by administrators of multiple-employer OPEB plans is also described in this statement when the fund used to accumulate assets and pay benefits or premiums when due is not a trust fund.

.119 The requirements of GASB Statement No. 43 for an OPEB plan are effective one year prior to the effective date of the related GASB Statement No. 45 for the employer (single-employer plan) or for the largest participating employer in the plan (multiple-employer plan). The requirements of GASB Statement No. 45 are effective in three phases based on a government's implementation phase for the purpose of GASB Statement No. 34. (See preceding explanation of Phase 1, 2, and 3 governments in the GASB Statement No. 34 discussion.) Plans in which the sole or largest participating employer was a Phase 1 government, for the purpose of implementation of GASB Statement No. 34, were required to apply the requirements of GASB Statement No. 43 in financial statements for periods beginning after December 15, 2005. Plans in which the sole or largest participating employer was a Phase 2 government, for the purpose of implementation of GASB Statement No. 34, should apply the requirements of GASB Statement No. 43 in financial statements for periods beginning after December 15, 2006. Plans in which the sole or largest participating employer was a Phase 3 government, for the purpose of implementation of GASB Statement No. 34, should apply the requirements of GASB Statement No. 43 in financial statements for periods beginning after December 15, 2007. Early implementation of GASB Statement No. 43 is encouraged.

GASB Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions

.120 This statement establishes standards of accounting and financial reporting for OPEB expense/expenditures and related liabilities or assets, note disclosures, and RSI in the financial statements of state and local governmental employers.

.121 The requirements of GASB Statement No. 45 are effective in three phases. Governments that were Phase 1 governments, for the purpose of implementation of GASB Statement No. 34, should apply the requirements of GASB Statement No. 45 in financial statements for periods beginning after December 15, 2006. Governments that were Phase 2 governments, for the purpose of implementation of GASB Statement No. 34, should apply the requirements of GASB Statement No. 45 in financial statements for periods beginning after December 15, 2007. Governments that were Phase 3 governments, for the purpose of implementation of GASB Statement No. 34, should apply the requirements of GASB Statement No. 45 in financial statements for periods beginning after December 15, 2008. All component units are required to implement the requirements of GASB Statement No. 45 no later than the same year as their primary government.

GASB Statement No. 47, Accounting for Termination Benefits

.122 This statement provides for the accounting and reporting of all forms of employment termination benefits for state and local governments, such as early-retirement incentives, severance pay, and other voluntary or involuntary benefits.

.123 The requirements of this statement are effective for financial statements in two parts. For termination benefits provided through an existing defined benefit OPEB plan, the provisions of GASB Statement No. 47 should be implemented simultaneously with the requirements of GASB Statement No. 45 (see the preceding discussion of GASB Statement No. 45 implementation). For all other termination benefits, GASB Statement No. 47 was effective for financial statements for periods beginning after June 15, 2005.

GASB Statement No. 48, Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues

.124 This statement establishes criteria that governments will use to ascertain whether the proceeds received from an exchange of an interest in their expected cash flows from collecting specific receivables or specific future revenues for immediate cash payments should be reported as revenue or as a liability. This statement also provides additional guidance for sales of receivables and future revenues within the same financial reporting entity. In addition, this statement includes a provision that stipulates that governments should not revalue assets that are transferred between financial reporting entity components. Therefore, any assets (or future revenues) sold or donated within the same financial reporting entity should continue to be reported at their current carrying value when those assets or future revenues are transferred. GASB Statement No. 48 is effective for periods beginning after December 15, 2006.

GASB Statement No. 49, Accounting and Financial Reporting for Pollution Remediation Obligations

.125 This statement addresses accounting and financial reporting standards for pollution remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities, such as site assessments and cleanups. The scope of the statement excludes pollution prevention or control obligations with respect to current operations and future pollution remediation activities that are required upon retirement of an asset, such as landfill closure and postclosure care and nuclear power plant decommissioning.

.126 GASB Statement No. 49 is effective for financial statements for periods beginning after December 15, 2007, with measurement of pollution remediation liabilities required at the beginning of that period so that beginning net assets can be restated. However, governments that have sufficient objective and verifiable information to apply the expected cash flow technique to measure the liability in prior periods are required to apply the provisions retroactively for all such prior periods presented.

Changes to the Financial Accounting Foundation, FASB, and GASB

.127 In February 2008, the Board of Trustees of the Financial Accounting Foundation (FAF) voted to approve major changes to the oversight, structure, and operations of the FAF and its two standard-setting boards, FASB and GASB.

.128 Specifically, the FAF Board of Trustees approved the following key changes:

- FAF changes include
  - — expanding the number and breadth of investors, accounting, business, financial, and government organizations and entities invited to nominate FAF trustees with the understanding that the final authority for all appointments rests solely with the discretion of the board of trustees;

— changing the current term of trustees from one three-year term with a possible second three-year term to one five-year term;

— changing the size of the board of trustees from a fixed 16 trustees to a flexible range of 14–18 trustees; and

— increasing the trustee governance activities, including its level of formal review, analysis, and oversight of the data and materials regularly provided by FASB, Financial Accounting Standards Advisory Council (FASAC), GASB, and Governmental Accounting Standards Advisory Council (GASAC).

- FASB changes include
    - — reducing the size of FASB from seven members to five, effective July 1, 2008;
    - — retaining FASB simple majority voting requirements;
    - — affirming the need for investor participation on FASB by broadening the current bylaw requirement that FASB members possess investment experience; and
    - — changing FASB's agenda-setting process whereby the FASB chair is vested with the authority, following appropriate consultation, to set FASB project plans, agenda, and priority of projects.
- GASB changes include
    - — securing a stable and permanent funding source for GASB;
    - — retaining the current size, term length, and composition of GASB; and
    - — changing GASB's agenda-setting process whereby the GASB chair is vested with the authority, following appropriate consultation, to set GASB project plans, agenda, and priority of projects.

FASB Accounting Standards Codification™

.129 State and local government auditors should take note of the FASB project to codify its accounting standards. GASB Statement No. 34 paragraph 93, states that proprietary funds should be reported based on all applicable GASB pronouncements as well as FASB Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedure issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. As a result, financial statement preparers have the responsibility to identify which provisions within the FASB pronouncements are applicable to them, while disregarding any amendments to such pronouncements made after that date.

.130 On January 15, 2008, FASB launched the one-year verification period of the *FASB Accounting Standards Codification™* (codification). The codification is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. The codification includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, Emerging Issues Task Force (EITF), and related literature. The codification also includes relevant authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance.

.131 The purpose of the codification is not to change GAAP, but rather to reorganize thousands of GAAP pronouncements into approximately 90 topics. Therefore, the one-year verification period is not to debate the underlying requirements of GAAP, but rather to verify that the codification appropriately captures them and accurately reflects existing U.S. GAAP for nongovernmental entities. The verification period is also a period for constituents to acquaint themselves with the new structure and submit feedback regarding any issues before the codification content becomes authoritative. At the end of the one-year verification period, FASB is expected to formally approve the codification as the single source of authoritative U.S. accounting and reporting standards, other than guidance issued by the SEC. At that time, FASB will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the codification will become nonauthoritative. FASB expects to approve the codification in April 2009.

.132 The codification of the FASB standards will make the GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, identification process more difficult and will likely result in the original FASB pronouncements becoming nonauthoritative. In response to this concern, the GASB is considering adding a project to its current technical agenda to codify these pre-November 30, 1989 FASB pronouncements as part of GASB's GAAP.

Summary of Recent Accounting Pronouncements and Related Guidance

.133 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. 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 GASB Web site at www.gasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

Recent Accounting Pronouncements and Related Guidance

GASB Statement No. 52 (November 2007)	*Land and Other Real Estate Held as Investments by Endowments*
GASB Statement No. 51 (June 2007)	*Accounting and Financial Reporting for Intangible Assets*
GASB Statement No. 50 (May 2007)	*Pension Disclosures—an Amendment of GASB Statements No. 25 and 27*

.134 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. The AICPA general *Audit Risk Alert—2007/08* and other AICPA industry-specific alerts also contain summaries of recent nongovernmental accounting pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.

GASB Statement No. 52

.135 In November 2007, GASB issued GASB Statement No. 52, *Land and Other Real Estate Held as Investments by Endowments*. This statement establishes consistent accounting and financial reporting standards for land and other real estate held as investment by endowments, including permanent funds. These investments will likely be encountered more often in colleges and universities and their related foundations than general-purpose governments. Endowments generally exist to invest resources for the purpose of generating income.

.136 This statement requires that land and other real estate held as investments by endowments be reported at fair value and the changes in fair value reported as investment income.

.137 This statement is effective for financial statements for periods beginning after June 15, 2008. Earlier application is encouraged.

GASB Statement No. 51

.138 GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, was issued in June 2007 to provide guidance regarding how to identify, account for, and report intangible assets.

.139 This statement requires that all intangible assets not specifically excluded by its scope provisions be classified as capital assets. Accordingly, existing authoritative guidance related to the accounting and financial reporting for capital assets should be applied to these intangible assets, as applicable. This statement also provides authoritative guidance that specifically addresses the nature of these intangible assets. Such guidance should be applied in addition to the existing authoritative guidance for capital assets.

.140 The guidance specific to intangible assets referred to in the preceding includes guidance on recognition. This statement requires that an intangible asset be recognized in the statement of net assets only if it is considered identifiable. Additionally, this statement establishes a specified-conditions approach to recognizing intangible assets that are internally generated. Effectively, outlays associated with the development of such assets should not begin to be capitalized until certain criteria are met. Outlays incurred prior to meeting these criteria should be expensed as incurred. This statement also provides guidance on recognizing internally generated computer software as an intangible asset. This guidance serves as an application of the specified-conditions approach described in the preceding to the development cycle of computer software.

.141 This statement also establishes guidance specific to intangible assets related to amortization. This statement provides guidance on determining the useful life of intangible assets when the length of their life is limited by contractual or legal provisions. If there are no factors that limit the useful life of an intangible asset, the statement provides that the intangible asset be considered to have an indefinite useful life. Intangible assets with indefinite useful lives should not be amortized unless their useful life is subsequently determined to no longer be indefinite due to a change in circumstances.

.142 The requirements of this statement are effective for financial statements for periods beginning after June 15, 2009; early implementation is encouraged. The provisions of this statement generally are required to be applied retroactively. For governments that were classified as Phase 1 or Phase 2 governments for the purpose of implementing GASB Statement No. 34, retroactive reporting is required for intangible assets acquired in fiscal years ended after June 30, 1980, except for those considered to have indefinite useful lives as of the effective date of this statement and those that would be considered internally generated. Retroactive reporting of intangible assets by Phase 3 governments is encouraged but not required. Retroactive reporting is not required but is permitted for intangible assets considered to have indefinite useful lives as of the effective date of this statement and those considered to be internally generated.

GASB Statement No. 50

.143 GASB Statement No. 50 was issued in May 2007. This statement more closely aligns the financial reporting requirements for pensions with those for OPEB and, in doing so, enhances information disclosed in notes to financial statements or presented as RSI by pension plans and by employers that provide pension benefits. The reporting changes required by this statement amend applicable note disclosure and RSI requirements of GASB Statement Nos. 25 and 27, to conform with the requirements of GASB Statement Nos. 43 and 45.

.144 This statement amends GASB Statement Nos. 25 and 27 to require defined benefit pension plans and sole and agent employers to present the following information related to note disclosures or RSI:

- Notes to financial statements should disclose the funded status of the plan as of the most recent actuarial valuation date. Defined benefit pension plans also should disclose actuarial methods and significant assumptions used in the most recent actuarial valuation in notes to financial statements instead of in notes to RSI.
- If the aggregate actuarial cost method is used to determine the annual required contribution of the employer (ARC), notes to financial statements should disclose the funded status of the plan and a schedule of funding progress should be presented as RSI, using the entry age actuarial cost method. Plans and employers also should disclose that the purpose of doing so is to provide information that serves as a surrogate for the funded status and funding progress of the plan.

- Notes to financial statements should include a reference linking the funded status disclosure in the notes to financial statements to the required schedule of funding progress in RSI.
- If applicable, notes to financial statements should disclose legal or contractual maximum contribution rates. In addition, if relevant, they should disclose that the maximum contribution rates have not been explicitly taken into consideration in the projection of pension benefits for financial accounting measurement purposes.
- If an actuarial assumption is different for successive years, notes to financial statements should disclose the initial and ultimate rates.

.145 This statement amends GASB Statement No. 25 to require defined benefit pension plans and defined contribution plans to disclose in the notes to financial statements the methods and assumptions used to determine the fair value of investments, if the fair value is based on other than quoted market prices.

.146 This statement amends GASB Statement No. 27 to require cost-sharing employers to include, in the note disclosure of the required contribution rates of the employer(s) in dollars and the percentage of that amount contributed for the current year and each of the two preceding years, how the contractually required contribution rate is determined (for example, by statute, by contract, or on an actuarially determined basis) or that the cost-sharing plan is financed on a pay-as-you-go basis.

.147 This statement also amends GASB Statement No. 27 to require that if a cost-sharing plan does not issue a publicly available stand-alone plan financial report prepared in accordance with the requirements of GASB Statement No. 25, as amended, and the plan is not included in the financial report of another entity, each employer in that plan should present, as RSI, the schedules of funding progress and employer contributions for the plan (and notes to these schedules). Each employer also should disclose that the information presented relates to the cost-sharing plan as a whole, of which the employer is one participating employer, and should provide information helpful for understanding the scale of the information presented relative to the employer.

.148 This statement is effective for periods beginning after June 15, 2007, except for requirements related to the use of the entry age actuarial cost method for the purpose of reporting a surrogate funded status and funding progress of plans that use the aggregate actuarial cost method, which are effective for periods for which the financial statements and RSI contain information resulting from actuarial valuations as of June 15, 2007 or later. Early implementation is encouraged. In the initial year of implementation, defined benefit pension plans and sole and agent employers that use the aggregate actuarial cost method to determine the ARC are required to present elements of information in the schedule of funding progress using the entry age actuarial cost method as of the most recent actuarial valuation date. In subsequent years, plans and employers should add to that schedule information as of subsequent actuarial valuation dates until the requirements of GASB Statement Nos. 25 and 27, as amended, with regard to the minimum number of years or actuarial valuations to be included, have been met.

Recent AICPA Independence and Ethics Pronouncements

.149 AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

On the Horizon

.150 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to state and local governments or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.151 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
Governmental Accounting Standards Board (GASB)	www.gasb.org
Financial Accounting Standards Board (FASB)	www.fasb.org
U.S. Government Accountability Office (GAO)	www.gao.gov
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Auditing Pipeline

ASB Clarity Project

.152 The ASB formed a Clarity Task Force to address concerns over the clarity, length, and complexity of GAAS. In March 2007, the ASB approved for exposure a discussion paper, *Improving the Clarity of ASB Standards*. In response to the feedback received on the discussion paper and subsequent discussions with interested parties, the ASB has established clarity drafting conventions. The clarity drafting conventions include the following:

- Establishing objectives for each of the standards
- Including a definitions section, where relevant, in each standard
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using an *A*-prefix and presenting them in a separate section that follows the requirement section

- Using formatting techniques, such as bullet lists, to enhance readability
- Including, where appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the standard
- Including, where appropriate, special considerations relevant to audits of governmental entities within the text of the standard

.153 The drafting conventions previously listed will be applied to all standards issued by the ASB after January 2008. In addition, over the next two or three years, the ASB will be redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections to *Professional Standards*), to apply the clarity drafting conventions and to converge with the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB). The ASB proposes that, except to address current issues, all redrafted standards will become effective at the same time. Only those standards needed to address current issues would have earlier effective dates. The ASB believes that a single effective date will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. Currently the date is expected to be for audits of financial statements for periods beginning no earlier than December 15, 2010. This date depends on satisfactory progress being made, and will be amended should that prove necessary. See the *Clarity Project Explanatory Memorandum* and the discussion paper *Improving the Clarity of ASB Standards* at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Improving+the+Clarity+of+ASB+Standards.htm.

Convergence With International Standards

.154 The ASB has created a number of task forces charged with monitoring specific activities of the IAASB and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of ISAs. The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Accounting Pipeline

.155 Presented below are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year alert have not been finalized as of the date of this writing, and thus are included again.

GASB Exposure Drafts

.156 The GASB has three exposure drafts of statements that it plans to finalize in 2008.

Service Efforts and Accomplishments

.157 In April 2008, the GASB issued an exposure draft of proposed changes to GASB Concepts Statement No. 2, *Service Efforts and Accomplishments Reporting*. This exposure draft proposes to update GASB Concepts Statement No. 2 to reflect knowledge gathered by GASB through 14 years of research and monitoring of such reporting. The proposed amendment would clarify the role of GASB in service efforts and accomplishments (SEA) reporting and to bring the conceptual framework up to date on the advances made by governments in reporting SEA information.

Fund Balance Reporting

.158 The exposure draft *Fund Balance Reporting and Governmental Fund Type Definitions* issued in February 2008, proposes to improve financial reporting and fund balance understanding by clarifying the definitions of governmental funds and establishing a hierarchy of fund balance classifications based on the extent to which a government is bound to observe spending constraints imposed on the use of resources reported in governmental funds. The exposure draft proposes that the requirements be effective for periods beginning after June 15, 2010.

Accounting for Derivatives

.159 The exposure draft *Accounting for Financial Reporting for Derivative Instruments*, issued in June 2007, addresses recognition and measurement of derivative instruments and disclosure of information about derivative instruments by state and local governments. A key provision in this proposed statement and a major change from current practice is that most derivative instruments covered in the scope of this proposed statement would be reported at fair value. Currently, most derivative instruments are recognized at historical prices in a government's statement of net assets. The disclosures of GASB Technical Bulletin No. 2003-1, *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*, generally have been incorporated into this proposal for hedging derivative instruments. The exposure draft proposes that the requirements would be effective for financial statements for periods beginning after June 15, 2009.

Upcoming GASB Due Process Documents

.160 GASB expects to release documents relating to a proposed accounting and financial reporting standard addressing the conceptual framework on recognition and measurement attributes in 2009.

> **Help Desk—**To track the progress of GASB's projects, go to the GASB's Web site at www.gasb.org. GASB generally posts exposure drafts on that site during the exposure period. It also posts its current technical plan listing and describes its projects and timetable.

Comprehensive Implementation Guide Update

.161 Annually, GASB publishes the annual update to its *Comprehensive Implementation Guide*. The *Comprehensive Implementation Guide* consolidates and updates previously issued guides for individual standards and provides current guidance on standards for which no standalone guides have been published.

> **Help Desk—**The *Comprehensive Implementation Guide* can be ordered through the GASB's order department at (800) 748-0659 or via its Web site at www.gasb.org.

Resource Central

.162 The following are various resources that practitioners engaged in the state and local government environment may find beneficial.

AICPA Governmental Audit Quality Center

.163 The GAQC is a firm-based, voluntary membership Center designed to improve the quality of governmental audits and the value of such audits to purchasers of governmental audit services. Governmental audits are audits and attestation engagements performed under *Government Auditing Standards* of federal, state, or local governments; not-for-profit organizations; and certain for-profit organizations, such as housing projects and colleges and universities that participate in governmental programs or receive governmental financial assistance. The GAQC keeps member firms informed about the latest developments, as well as provides tools and information to help them better manage their audit practice. Firms that join demonstrate their commitment to audit quality by agreeing to adhere to certain membership requirements.

.164 The GAQC has been in existence since September 2004. Since its launch, Center membership has grown to over 980 firms from 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. The membership accounts for approximately 81 percent of the total federal expenditures covered in single audits performed by CPA firms in the Federal Audit Clearinghouse database (http://harvester.census.gov/sac/) for the year 2006 (the latest year with complete submission data).

.165 The Center's focus is to promote the highest quality audits and to save firms time by providing a centralized place to find information they need, when they need it, to maximize quality and practice success. Center resources include the following:

- E-mail news alerts on current audit and regulatory developments that keep member firms informed about the latest developments
- Dedicated Center Web site at www.aicpa.org/GAQC with resources, community, events and products, and a complete listing of GAQC members in each state
- Online member discussion forums for sharing best practices and discussing issues firms are facing
- Webcasts, Web seminars, and teleconferences updating members on a variety of technical, legislative, regulatory, and practice management subjects (note that these activities are archived on the GAQC Web site)

> **Help Desk—**With all of the quality issues being noted in governmental audits (see further discussion in the "Legislative and Regulatory Developments" and "Audit and Attestation Issues and Developments" sections), your firm should consider joining the Center. To enroll or learn more about the GAQC, including details on the membership requirements and fees for membership, go to www.aicpa.org/GAQC or e-mail GAQC staff at GAQC@aicpa.org. To preview member benefits, go to http://gaqc.aicpa.org/Memberships/.

AICPA Industry Expert Panel—State and Local Governments

.166 The State and Local Government Expert Panel is an AICPA volunteer group whose purpose it is to identify state and local government financial reporting and auditing issues and to work with appropriate bodies for resolutions benefiting the public interest; to conduct liaison activities with the GASB, regulators such as the GAO and OMB, and applicable industry associations; and to advise and assist in the development of AICPA products and services related to state and local government audits. For information about the activities of the State and Local Government Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_government.htm.

Publications

.167 Practitioners may find the following publications useful with respect to state and local governments:

- Audit and Accounting Guide *State and Local Governments* (2008) (product no. 012668kk)
- Audit Guide Government Auditing Standards *and Circular A-133 Audits* (2007) (product no. 012747kk)
- Audit and Accounting Guide *Health Care Organizations* (2007) (product no. 012617kk)
- Audit Guide *Audit Sampling* (2008) (product no. 012538kk)
- Audit Guide *Analytical Procedures* (2008) (product no. 012558kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)

- Audit Guide *Auditing Derivative Instruments,Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2008) (product no. 012518kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2008) (product no. 012778kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- AICPA Audit Risk Alert Government Auditing Standards *and Circular A-133 Audits—2007/08* (product no. 022457kk)
- AICPA Audit Risk Alert *Health Care Industry Developments—2007/08* (product no. 022348kk)
- Audit Risk Alert *Compilation and Review—2007/08* (product no. 022308kk)
- Audit Risk Alert *Independence and Ethics—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *State and Local Governments: Checklists and Illustrative Financial Statements* (2007) (product no. 009037kk)
- Audit and Accounting Practice Aid *Applying OCBOA in State and Local Governmental Financial Statements* (product no. 006614kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Requirements* (product no. 006627kk)

AICPA reSOURCE: Accounting and Auditing Literature

.168 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. 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.

Continuing Professional Education

.169 The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's AnnualAccounting and Auditing Update Workshop* (2008–2009 Edition) (product no. 736184kk [text] or 187192kk [DVD]). 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.
- *Internal Control Deficiencies: Assessment and Reporting Under SAS 112* (product no. 733291kk [text] or 183291kk [DVD]). This course focuses on compliance with the standard's requirement by examining each stage of the decision making framework using numerous illustrations and practice exercises. The course also applies to managers of nonpublic companies to enable them to decide whether a control deficiency exists and how to correct it.

.170 Among the many courses, the following are specifically related to state and local governments:

- *State & Local Government Strategic Briefing—2007/2008* (product no. 780100HSkk [CD-ROM]). This course, based on a webcast, provides participants with a strategic look at what's important in the governmental accounting and auditing area. The program addresses recently issued GASB pronouncements affecting both preparers and auditors and feature highlights of recently issued GAAS, and the latest updates to the AICPA Audit and Accounting Guide *State and Local Governments*.
- *Foundations in Governmental Accounting* (product no. 731645kk). This course features the fundamental tenets of governmental accounting and reporting in the post-GASB Statement No. 34 environment. Learn more than the buzz words—learn the underlying concepts and how they are applied.
- *Governmental Accounting and Auditing Update (2008/2009 Edition)* (product no. 736478kk [text] or 186484kk [DVD]). This timely, up-to-the-minute course is designed to provide you with a comprehensive understanding of new developments, so you can provide better services to both clients and the public. For 2008–09, the course includes coverage of the new Yellow Book, the risk assessment SASs, SAS No. 112, and more.
- *Workpaper Techniques for Government and Nonprofit Organizations* (product no. 732637kk). Learn to prepare workpapers needed to complete a government or nonprofit audit. Increase your performance with practical and timesaving techniques. Avoid common preparation problems by applying proven, effective strategies.
- *Government Accounting and Reporting: Putting It All Together* (product no. 732803kk). This course goes deep into the accounting and reporting issues for state and local governments. Learn how to navigate the complexities of government accounting and reporting in the post-GASB Statement No. 34 environment.
- *Audits of HUD-Assisted Projects* (product no. 730299kk). Gain in-depth, hands-on information regarding Housing and Urban Development (HUD) organization, programs, policies, and procedures. Review the professional standards affecting specific federal programs.

.171 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.172 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to state and local government accountants and auditors include the following:

- *Government Accounting and Reporting: Preparing the Government-Wide Financial Statements*
- *Yellow Book: An Overview*
- *2007 Annual Update—Government: GASB Activities*
- *Governmental and NPO Workpaper Preparation Techniques Overall Approach*
- *Fraud in Exempt Organizations: The Governmental and Not-for-Profit Environments*

.173 To register or learn more, visit www.cpa2biz.com.

Webcasts

.174 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

Member Service Center

.175 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.176 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9am to 8pm on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

.177 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.

Industry Conferences

.178 The AICPA sponsors three annual Governmental Accounting and Auditing Conferences in the late summer and fall.

.179 *Governmental Accounting and Auditing Update Conference (GAAC) EAST* is held in late summer in Washington, D.C., and its counterpart *Governmental Accounting and Auditing Update Conference (GAAC) WEST* takes place in Denver, Colorado in early fall. These conferences are designed for CPAs working in federal, state, and local government; public practitioners with government auditees; and regulators who need to be aware of emerging developments; these CPAs should attend this conference to remain current on the issues. Attending one of these conferences is a great way to receive timely guidance along with practical advice on how to handle new legislation and standards from key government officials and representatives of the accounting profession—including the standard setters themselves.

.180 *AICPA National Governmental and Not-for-Profit Training* is held in Las Vegas, Nevada. If you need hands-on training and are a CPA in public practice—or a governmental or not-for-profit staffer—then this conference is for you. You'll hear directly from the standards setters and industry leaders on a variety of topics including developments in governmental accounting and auditing, the latest in proposed regulations and laws on the local, state, and federal government levels, as well as those affecting the not-for-profit sector and more.

.181 For further information about these conferences, call (888) 777-7077 or visit www.cpa2biz.com.

Industry Web Sites

.182 The Internet covers a vast amount of information that may be valuable to auditors of state and local government entities, including current industry trends and developments. Some of the more relevant sites for auditors with governmental clients include those shown in the following table:

Organization	*Web Site*
Association of Governmental Accountants (AGA)	www.agacgfm.org
Catalog of Federal Domestic Assistance (CFDA)	www.cfda.gov
Federal Audit Clearinghouse (FAC)	http://harvester.census.gov/sac
U.S. Government Accountability Office (GAO)	www.gao.gov
Government Auditing Standards (Yellow Book)	www.gao.gov/govaud/ybk01.htm
Governmental Accounting Standards Board (GASB)	www.gasb.org
Financial Accounting Standards Board (FASB)	www.fasb.org
Securities and Exchange Commission Information for Municipal Markets	www.sec.gov/info/municipal.shtml
Government Finance Officers Association (GFOA)	www.gfoa.org
National Association of Local Government Auditors (NALGA)	www.governmentauditors.org
National Association of State Auditors, Comptrollers, and Treasurers (NASACT)	www.nasact.org
Offices of Inspectors General (OIG)	www.ignet.gov
Office of Management and Budget (OMB)	www.whitehouse.gov/OMB
President's Council on Integrity and Efficiency (PCIE)	www.ignet.gov/pcieecie1.html

.183 The state and local government practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

* * * *

.184 This Audit Risk Alert replaces *State and Local Governmental Developments—2007*.

.185 The Audit Risk Alert *State and Local Governmental Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to ccole@aicpa.org or write to

Christopher Cole, CPA, CFE
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

Appendix—Additional Web Resources

.186

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org

Web Site Name	*Content*	*Web Site*
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee (PCFRC)	Information on the initiative to further improve FASB's standard-setting process to consider needs of private companies and their constituents of financial reporting.	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov

[*The next page is 8221.*]

AAM Section 8080

Common Interest Realty Associations Industry Developments—2006/07

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
COMMON INTEREST REALTY ASSOCIATIONS
INDUSTRY DEVELOPMENTS—2006/07

This Audit Risk Alert, prepared by the AICPA staff, is intended to provide auditors of financial statements of common interest realty associations with an overview of recent economic, technical, 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. 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.

Lori A. West, CPA
Technical Manager
Accounting and Auditing Publications

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How This Alert Helps You

.01 This Audit Risk Alert helps you plan and perform your common interest realty association (CIRA) audits, reviews, and compilations. 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 current accounting, auditing, and regulatory developments.

.02 ***References to Professional Standards***. When referring to the professional standards, this Alert cites the applicable sections of the codification and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54 is referred to as AU section 317 of the AICPA *Professional Standards*.

Help Desk—See the AICPA Audit Risk Alert *Independence and Ethics Alert—2006/07* (product no. 022477kk) for a thorough discussion of recent developments and key issues in the area of independence and ethics.

Help Desk—See the AICPA Audit Risk Alert *Compilation and Review Alert—2006/07* (product no. 022307kk) for a thorough discussion of recent developments and key issues in the area of compilations and reviews.

.03 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 and understanding that industry information.

Understanding the Organization and Its Environment and Assessing Risks

.04 An auditor should obtain an understanding of relevant industry, regulatory, and other external factors. These factors include the following:

- Industry conditions
- The regulatory environment encompassing, among other matters, relevant accounting pronouncements
- The legal and political environment
- Other external factors, such as general economic conditions

.05 The CIRA industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive).

.06 The auditor should obtain an understanding of the CIRA's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the organization's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. An understanding of business risks increases the likelihood of identifying risks of material misstatement, although the auditor does not have a responsibility to identify or assess all business risks. Many business risks could eventually have financial consequences and, therefore, affect the financial statements; obviously, however, not all business risks give rise to risks of material misstatement.

.07 After gaining an understanding of the organization and its environment, the auditor needs to make risk assessments at the financial statement and relevant assertion levels based on that understanding.

.08 Presented in this Alert are current business, economic, regulatory, accounting, and auditing matters that may affect your clients. Reading about these matters and properly addressing them as necessary will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and ultimately strengthen the integrity of your audits.

Current Economic and Industry Developments

.09 For a complete overview of the current economic environment in the United States, see the AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk).

Residential Community Association Demographics

.10 In 1970, there were approximately 700,000 homes in 10,000 community associations. As part of a mid-1970 report, the U.S. Department of Housing and Urban Development (HUD) projected that 50 percent of American homes would be living in community associations by the late 1980s. Although premature, the HUD prediction was not that wrong. Today, it is estimated that 85 percent to 90 percent of all *new for-sale housing* is located in one of the three basic types of community associations. Somewhere between 40 percent and 60 percent of CIRAs are contract managed by specialized community association management (CAM) companies while the other 40 percent to 60 percent are self-managed either solely by volunteers or with association-hired staff. Regardless of management structure, all associations are governed by a volunteer board of directors elected by the membership.

Quick Facts About Residential Community Associations

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
No. of CIRAs	222,500	231,000	240,000	249,000	260,000	273,600	286,000
No. of CIRA housing units	17,800,000	18,480,000	19,200,000	19,920,000	20,800,000	22,160,000	23,100,000
CIRA population	45,200,000		48,000,000		51,800,000	54,600,000	57,000,000
U.S. population	281,001,000		287,123,000		295,084,000		306,100,000

.11 Housing cooperatives represent approximately 5 percent to 7 percent of all association units. Condominium associations represent from 38 percent to 42 percent while planned communities constitute the balance. Condominium associations, in the last two to three years, have definitely increased in acceptability and popularity.

Boards of Directors—Value of Service

.12 Over 1.7 million volunteers serve on the boards of directors of residential community associations with another 375,000 participating as committee members. There are 286,000 annual association meetings with democratically conducted elections and another nearly 2,600,000 board of directors meetings during the year in which owners debate and shape their housing community's future. To assist the board, there are over 900,000 committee meetings during each fiscal year. The estimated value of these governance services is about $370,000,000. In general, about 28 percent of the eligible U.S. population volunteers at some point during a year—association leaders volunteer continuously during a year.

.13 When planning an audit the auditor of a CIRA should assess the board members' level of experience or whether there is a small group of homeowners who control the CIRA and have done so for years. Since a CIRA's environment is unique in that volunteers help manage large assets with little or no experience and minimal oversight, the auditor's approach will vary depending on which situation is relevant.

Annual Assessments

.14 These boards supervise the collection of over $41 billion in annual assessments and maintain investment accounts of another $36 billion to $37 billion for the long-term maintenance and replacement of commonly held property.

Reserves for Major Repairs

.15 During the course of any given year, associations probably spend in excess of $20 billion from accumulated reserves and operating funds for the repair, replacement, and enhancement of commonly owned property. According to a recent survey by the National Association of Housing Cooperatives, the average cooperative (which is about 25 years older than the typical condominium) plans to spend $1 million on repairs in the next five years.

Regulatory and Legislative Developments

.16 The operations of CIRAs, especially condominium associations, are regulated by the individual states and not by the federal government. Alternatively, planned communities (that is, homeowners associations [HOAs], property owners associations [POAs], and cooperatives), may not be regulated by the states. However, federal regulations, court cases, Internal Revenue Service (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), the Freddie Mac and the Fannie Mae, have regulations and underwriting guidelines to guide developers, mortgage lenders, and others in establishing CIRAs as well as in selling and financing 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 HUD requirements, IRS private letter rulings, and bankruptcy legislation. Readers should be aware that some states, especially three states—California, Florida, and Nevada—have active state agencies and a fourth state, New York, has a long history of involvement by the attorney general.

> **Help Desk**—To obtain copies of the HUD handbooks, notices, and other documents, go to www.hudclips.org, where they are available for printing or viewing. Printed handbooks can be ordered online through the Direct Distribution System or by telephone at (800) 767-7468.

Internal Revenue Service Activities

IRS Revenue Rulings

.17 A revenue ruling is an official interpretation by the IRS of the Internal Revenue Code (IRC), related statutes, tax treaties, and regulations. It is the conclusion of the IRS on how the law is applied to a specific set of facts. Revenue rulings are published in the Internal Revenue Bulletin for the information of and guidance to taxpayers, IRS personnel, and tax professionals. They can be used as guidance if your client encounters a similar situation. Readers should periodically review IRS revenue rulings as they may affect CIRAs.

> **Help Desk**—For more information, go to www.irs.gov/businesses/article/0,,id=107937,00.html for complete revenue ruling and memorandums issued to examiners. The Industry Issue Resolution (IIR) Program is aimed at establishing consistent IRS positions on complicated or controversial tax issues.

Technical Advice Memoranda (TAMs)

.18 Technical Advice Memoranda (TAMs) are written determinations issued by the National Office of the Internal Revenue Service that interpret and apply tax law to a taxpayer's specific set of facts. TAMs are not legally binding and may not be used as precedent in other cases. TAMs only address a particular factual situation, and different facts could change the advice given. However, TAMs can indicate IRS thinking on an issue. Below are some TAMs that have been issued that may be helpful to CIRAs.

.19 ***TAM 9539001—National Office Technical Advice Memorandum Letter Ruling 9539001.*** (Note: This involved a time-share association.)

.20 Conclusions (as shown in the TAM):

1. Amount received as annual assessments from taxpayer's members in excess of annual expenses are includible in taxable income.
2. Prepaid member assessments collected in one year but allocable to the next budget year are includible in gross income in the year of receipt.
3. Member assessments allocated to various repair and replacement reserve accounts are includible in gross income in the year of receipt.

.21 The conclusions were based on the fact that the association did not have as its sole activity the management and maintenance of the common areas, but had maid service and furnished individual units. Also, the members-owners were not given the opportunity to vote on the 70-604 election. Furthermore, no separate reserve bank account was set up for reserves.

.22 ***TAM 9637007—National Office Technical Advice Memorandum Letter Ruling 9637007.*** (The Association developed a portion of its unused property with condominiums which were offered for sale to members and to nonmembers on the condition that nonmembers become members prior to purchase.)

.23 Conclusions (as shown in the TAM):

> Section 277(a) applied to the taxpayer and income from the condominium sales is income from transactions with members. Accordingly, any condominium sale income can only be offset by expenses of providing goods and services to members. Expenses of development and sale of the condominium project, to the extent of the deductible, can only be deducted with respect to member income.

.24 The IRS written determinations can be viewed by going to the following link: www.irs.gov/foia/lists/0,,id=97715,00.html

Special Tax Issue Related to Mixed-Use Projects

.25 The residential real estate industry continues to see the development of numerous mixed-use projects. Mixed-use development is the result of land planning that combines space for residential and commercial use. Many of these mixed-use projects contain for-sale units and therefore involve a CIRA component. The following tax issue which will need to be addressed in the annual audit is the CIRA taxation for mixed-use projects. There are several tests that a CIRA must meet in order to file IRS Form 1120-H. One key test for a mixed-use CIRA is the substantially residential test. Treasury Regulation 1.528-4 states the following:

> In general, in order for an organization to be considered a condominium management association or a residential real estate management association (and therefore in order for it to be considered a homeowners association), substantially all of its units, lots or buildings must be used by individuals for residences. For the purposes of applying paragraph (a) or (b), an organization which has attributes of both a condominium management association and a residential real estate management association shall be considered that association which, based on all the facts and circumstances, it more closely resembles. In addition, those paragraphs shall be applied based on conditions existing on the last day of the organization's taxable year.
>
> **Treasury Regulation § 1.528-4. Substantially Residential Test.**
>
> (a) *Condominium Management Associations*. Substantially all of the units of a condominium management association will be considered as used by individuals for residences if at least 85% of the total square footage of all units within the project is used by individuals for residential purposes. If a completed unit has never been occupied, it

will nonetheless be considered as used for residential purposes if, based on all the facts and circumstances, it appears to have been constructed for use as a residence. Similarly, a unit which is not occupied but which has been in the past will be considered as used for residential purposes if, based on all the facts and circumstances, it appears that it was constructed for use as a residence, and the last individual to occupy it did in fact use it as a residence. Units which are used for purposes auxiliary to residential use (such as laundry areas, swimming pools, tennis courts, storage rooms and areas used by maintenance personnel) shall be considered used for residential purposes.

(b) *Residential Real Estate Management Associations*. Substantially all of the lots or buildings of a residential real estate management association (including unimproved lots) will be considered as used by individuals as residences if at least 85% of the lots are zoned for residential purposes. Lots shall be treated as zoned for residential purposes even if under such zoning lots may be used for parking spaces, swimming pools, tennis courts, schools, fire stations, libraries, churches and other similar purposes which are auxiliary to residential use. However, commercial shopping areas (and their auxiliary parking areas) are not lots zoned for residential purposes.

(c) *Exception.* Notwithstanding any other provision of this section, a unit, or building will not be considered used for residential purposes, if for more than one-half the days in the association's taxable year, such unit, or building is occupied by a person or series of persons, each of whom so occupies such unit, or building for less than 30 days. Such an example would be timeshares.

.26 See the following link to the Tax Almanac for the further guidance: www.taxalmanac.org/index.php/Treasury_Regulations%2C_Subchapter_A%2C_Sec._1.528-4.

Compilation and Review Issues

Consideration of Fraud and Illegal Acts in a Compilation or Review Engagement

.27 Fraud is a broad legal concept and accountants do not make legal determinations of whether an act is, in fact, fraudulent. Rather, the accountant's interest specifically relates to acts that result in a material misstatement of the financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. Fraud is an intentional act that results in a material misstatement in financial statements.

.28 Guidance in AR section 100.05, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), states that the accountant should, among other things, establish an understanding with the entity that provides that the accountant will inform the appropriate level of management of any fraud or illegal acts that come to his or her attention, unless they are clearly inconsequential. This amendment revises AR section 100 by requiring the accountant to:

1. Establish an understanding with the client, preferably in writing, that the accountant will inform the appropriate level of management of any evidence or information that comes to the accountant's attention during the performance of compilation or review procedures that fraud or an illegal act may have occurred.
2. Report, to the appropriate level of management, any evidence or information that comes to the accountant's attention during the performance of compilation or review procedures that fraud or an illegal act may have occurred.

.29 The accountant need not report matters regarding illegal acts that are clearly inconsequential and may reach agreement in advance with the entity on the nature of such items to be communicated.

.30 Statement on Standards for Accounting and Review Services (SSARS) No. 12, *Omnibus Statement on Standards for Accounting and Review Services—2005* (AICPA, *Professional Standards*, vol. 2), does not add additional procedures to those normally performed in a compilation or review engagement. In other words, there is no requirement in a compilation or review engagement to search for fraud or illegal acts.

.31 However, during the performance of compilation or review procedures, if any evidence or information comes to the accountant's attention regarding fraud or an illegal act that may have occurred, the accountant should request that management consider the effect of the matter on the financial statements. Additionally, the accountant should consider the effect of the matter on his or her compilation or review report. When compiling financial statements and circumstances arise where the accountant believes that the financial statements are materially misstated, the accountant should obtain additional or revised information. When reviewing financial statements and circumstances arise where the accountant believes that the financial statements are materially misstated, the accountant should perform the additional procedures deemed necessary to achieve limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA).

> **Help Desk—**See the AICPA Audit Risk Alert *Compilation and Review Alert—2006/07* (product no. 022307kk) for a thorough discussion of recent developments and key issues in the area of compilations and reviews.

Engagement Issues

Reserve Study Concerns

.32 One of the critical components of the overall operating budget for a CIRA is the reserve study. Annual contributions to the replacement fund may be based on a reserve study which is developed to determine the timing and costs for future major repairs and replacements. While CIRAs often fund these costs through contributions over the lives of the common area components, CIRAs also fund the costs by assessing owners when funds are needed, or by borrowing. A CIRA should disclose information in its financial statements about its funding for future major repairs and replacements. The boards of directors need to be aware that the goal of whatever policies they set should be to enable them to meet their fiduciary duties to maintain and preserve the common property as stated in paragraph 3.05 of the AICPA Audit and Accounting Guide *Common Interest Realty Associations* (the CIRA Guide) as of May 1, 2006. The auditor should review the reserve study and compare it to the actual occurrences to determine if further procedures should be performed in assessing the reasonableness of the estimates and assumptions utilized (see the discussion of those procedures under the "Aging Communities" subhead below). The study also provides the CIRA with a funding strategy which is based upon its specific circumstances.

.33 The most critical times for the CIRA with regard to the development of the reserve study and the funding strategies occur when:

- The budget is first established for the new community which is either new construction or a conversion.
- The budget is reviewed while the replacements are becoming necessary.
- Each year the CIRA reviews its study and makes a decision regarding the funding plan to be implemented.

.34 In order to develop the reserve study, a number of variables needs to be defined. The auditor should understand the reserve study process, even though they may not be responsible for the generation of the study. They are as follows:

- *Common area components.* The first and most important is the selection of components, individual line items found in the physical analysis which encompass the common elements, to be included within the study. The CIRA is responsible for the maintenance and replacement of its common elements, which are described in the governing documents. Common elements vary based upon the type of CIRA. For example, when dealing with a condominium association, the common elements typically comprise not only the exteriors of the building but also the site-related items such as the driveways and other paved roadways, sidewalks, lobbies, and any other amenities. When dealing with a homeowners association (also known as a planned unit development and other terminology nationally), the common elements typically do not include the residential buildings, although they still include the site work and amenities such as the clubhouse, roads, and lighting. For this reason, it is important to understand the descriptions of the common elements as defined in the governing documents.

- *Replacement cost.* This is the estimated cost for performing the replacement when it becomes necessary. Generally, this is expressed as a unit cost and is multiplied by the overall quantity of that component. For example, the roadways comprise 1,000 square yards of area with a replacement cost of $7.00 per square yard thus yielding a total replacement cost of $7,000.

- *Beginning balance.* This is the amount of money which has been accumulated prior to the preparation of the study. This amount is distributed to each of the components within the study based upon a weighting factor. In the table in Example 1, this amount is $9,000.

- *Estimated useful life.* This is the amount of time in which a component can adequately operate before 100 percent replacement is required. In Example 1, for the pavement this would be 20 years. Depending on the state and/or the practice in a given area, components with 30 or more years may be treated as having an unlimited useful life and, hence, no replacement fund is created for that component. Domestic water piping, electric lines, and structural supports are examples.

- *Estimated remaining useful life.* This is based upon the condition and age of the component inspected at the time the study is performed. In Example 1, for the pavement this would be 10 years.

.35 While the fundamental information regarding reserve studies is essentially the same for all circumstances, the risks involved at the different times in the life of the CIRA are significantly different and are discussed below.

Background

.36 The concept of a reserve study is relatively simple and includes two parts, the physical analysis and the financial analysis. The physical analysis contains information about the physical status and replacement cost of major common area components the CIRA is obligated to maintain. It comprises component inventory, condition assessment, and life estimates. The financial analysis includes the evaluation of the CIRA's reserve balance, income, and expenses. It involves assessing the current replacement fund status and an appropriate funding plan.

.37 The physical analysis is based upon a calculation in which the replacement cost of a particular component is amortized over the life of that component. Thus, when it is time for the replacement to occur, the CIRA should have theoretically accumulated adequate funds for that replacement. An example would be the necessity to replace the roadways within the community. If the replacement cost of the roadways is $7,000, $1,750 has already been accumulated, and the estimated time period before replacement is required is 10 years, the CIRA would need to accumulate $525 per year so that the $7,000 is available when needed ($7,000 minus $1,750 = $5,250 divided by 10 years = $525 per year). This scenario can be seen in the table in Example 1.

.38 The financial analysis is based upon the creation of a cash flow projection of the amount of funds to be set aside each year, for all components which make up the physical analysis. Based upon this cash flow, the annual contributions are sought to be minimized while simultaneously allowing for sufficient funds to exist over the cash flow period such that a deficit does not occur. The resulting cash flow becomes the funding plan for the CIRA. There are four types of funding plans, three of which can be seen in the graph in Example 2. It is recommended that the CIRA review its funding plan on a yearly basis to determine if it still reflects its current financial situation.

.39 The four types of funding plans are described below:

- *Full/proportional funding*. In this funding plan each of the individual components is funded fully. This is generally considered to be the most conservative plan as excess funds may accumulate. It does not account for the cash flow projections. An example of full/proportional funding can be seen as the top line in Example 2. Note that over the cash flow period a significant amount of money continuously exists in the fund.

- *Baseline funding*. In this funding plan, the annual contributions are lowered so that at some point in the cash flow projection the replacement fund balance is equal to $0. This is the least conservative method because a budget deficit can occur if replacement costs are underestimated or if a component requires replacement before its estimated useful life is realized. An example of baseline funding can be seen as the bottom line in Example 2.

- *Threshold funding*. In this funding plan, the annual contributions are adjusted so that the minimum point in the cash flow is something other than full/proportional funding or baseline funding. Typically this point is somewhere between the two and will provide adequate funding over the cash flow period without fear of either a deficit or overfunding. Annual contributions are reduced so the cash flow projection is lowered but is never $0. The level of the threshold varies with each CIRA and is typically based on the cost of the most expensive component to be replaced and the size of the CIRA's overall budget. An example of threshold funding can be seen as the middle line in Example 2.

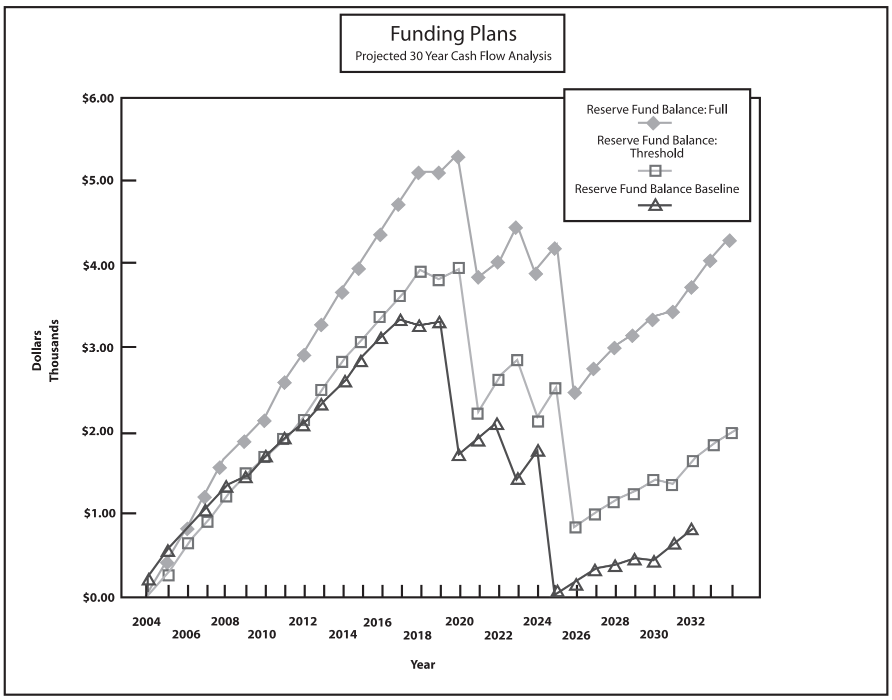
- *Statutory funding*. Although not discussed in detail, in some states governmental regulations exist which require certain levels of reserves to be accumulated. The original governing documents should comply with these regulations.

.40 The risks associated with the selection of the CIRA's funding plan are twofold. The reserves can either be overfunded, resulting in an excess amount of inactive assets, or underfunded, resulting in a deficit at the time of component replacement. In order to minimize these risks, the CIRA should review its reserve study each year regarding the type of funding plan and the respective risks. It should balance the potential for a deficit against the cost of regular updates of the study which will incorporate current replacement costs and estimated remaining lives. The auditor may consider using the management representation letter as a way for the CIRA and its management to acknowledge the funding plan that is being utilized. In the case of baseline funding, yearly updates are prudent as expenditures may exceed estimates or may be required earlier in the respective component's useful life than expected, which can trigger a cash flow hurdle for the CIRA. In contrast, in the case of full/proportional funding, three to four years between updates may be acceptable. In terms of overfunding reserves, it should be recognized that while full/proportional funding is the most conservative method, it may provide for more than adequate funding and the imprudent use of CIRA funds. CIRAs that assess owners annually for portions of future major repairs and replacements should report those assessed amounts separately from amounts assessed for normal operations. If a CIRA uses fund reporting, which is more informative to users, as stated in paragraph 4.02 of the CIRA Guide, amounts assessed for future major repairs and replacements should be reported in the major repair and replacement fund separately from transactions in the operating fund. Note this is the assessed/budgeted amount, not the actual monies transferred. Transfers between funds that are not part of the current-period operating revenues should be presented only in a statement of changes in fund balances or in a statement of changes in members' equity, if a nonfund reporting approach is used. This would include when a board chooses not to fund in accordance with its budget, as well as other decisions related to monies between funds. Readers should refer to paragraphs 4.27 and 4.33 of the CIRA Guide for recommended disclosures.

Example 1: The Physical Analysis

Common Area Component	Quantity	Unit Cost	Reserve Requirement (Present Dollars)	Beginning Balance	Estimated Useful Life	Estimated Remaining Useful Life	Annual Reserve Funding Required
Pavement overlay	1000 SY	$7.00	$7,000	$1,750	20	10	$525
Concrete sidewalks	1500 SF	$6.00	$9,000	$2,250	30	15	$450
Roofs	200 SQ	$100	$20,000	$5,000	22	11	$1,364
Total			**$36,000**	**$9,000**			**$2,339**

Example 2: The Financial Analysis



Concerns at Inception of the CIRA

.41 CIRAs may be required by state statutes, mortgage documents, or their governing documents to set aside funds on a systematic basis for future major repairs and replacements. The auditor should review the CIRA's governing documents and relevant state statutes to determine whether such requirements exist. The auditor should also review the CIRA's policy for accumulating the required funds.

.42 Generally, when a developer/builder plans a CIRA, whether it is new construction or a conversion, governing documents are prepared for the CIRA—including the type of CIRA and descriptions of the community, and the initial operating budget, which may also contain the initial reserve study. There may also be an engineer's report and a detailed public offering statement (POS). These governing documents also include a description of the common elements which will be the responsibility of the CIRA to maintain and replace as opposed to those components which are the responsibility of the individual unit owners. At this stage, a number of concerns must be taken into account. When the document is prepared for new construction, in many cases the construction has not yet been completed or even commenced. As is typical with most construction, field changes may occur such that the as-built community does not match the design drawings. Since the reserve study was based on the design drawings, it too will no longer match the as-built community. This may result in underfunding of the project. To minimize this concern, it is recommended that the study included within the governing documents be updated to reflect the as-built community either by the new homeowners or by the developer/builder, depending upon the time for the build-out of the entire community.

.43 Another concern at this time is that in some instances the governing documents are being prepared at the same time as the reserve study. Concerns are triggered if inconsistencies arise. To minimize these concerns, it is necessary that the coordinator of the reserve study be in contact with the creator of the documents so the reserve study reflects the descriptions of common elements consistently.

.44 Once the components are selected, a determination of the quantities of each of the components is taken from the design documents, which typically include the architectural drawings for the buildings and the engineering drawings for the site. Based upon a review of these documents and an understanding of the materials of construction, the estimated lives are determined. In the case of new construction, since the community has not yet been constructed, the estimated remaining life and the estimated full useful life are the same. Also, execution of the project may differ from already established plans, thereby creating risk through inconsistencies. To minimize this concern, and as discussed above, it is recommended again that either the developer or the CIRA have the original reserve study included within the governing documents updated to reflect both the quantities of the actual as-built construction as well as the materials. The replacement costs should also be updated. If this type of update is not performed and there are discrepancies between the design documents and the as-built construction, the adequate funding may not exist and will become more and more critical since this potential underfunding is cumulative as time progresses. This type of concern in some instances may affect the smooth transfer of control from the developer/builder to the new unit owners as they take control of the CIRA during the period known as transition.

.45 In the situation in which the newly formed CIRA is a conversion from another use and not a new construction, another concern arises. This concern is based upon the fact that the components which constitute the common elements are not new and have reduced useful lives. While with both new construction and conversions the beginning balance in the reserve account is $0, in the case of the conversion and the reduced useful lives, the replacement costs must be amortized over this reduced life which subsequently will result in higher annual contributions. In many instances the reduced useful lives are not accounted for in the reserve study, resulting in unanticipated replacements and inadequate funds at the time of these replacements. To minimize this concern, it is recommended that particular attention be paid to the condition of all of the components and that the reduced useful lives are reflected in the study.

Aging Communities

.46 For an aging community, the result of an underfunding of the replacement fund portion of the budget becomes especially critical if the CIRA has not been performing regular updates of the reserve study from the initial governing documents. In many instances the CIRA has also neglected the necessary ongoing maintenance of the common elements, which becomes more obvious as the CIRA ages. This lack of maintenance can have a significant impact on the estimated useful lives. If the study has not been updated, this can compound the problem since the reduction in useful lives is not recognized until the replacements are required. In order to minimize the risk associated with an aging community, it is recommended that as CIRAs age, the studies be updated on a more frequent basis and in some cases yearly. These updates should include a field inspection to reflect the actual condition of the components. At the same time a thorough review should be made of the funding plan selected to determine if it is still appropriate for the CIRA.

.47 A complete description of the requirements for the preparation of a reserve study can be found in the publication titled "National Reserve Study Standards of the Community Associations Institute" which is published by the Community Associations Institute (CAIOnline.org).

.48 The auditor should apply certain limited procedures to the required supplementary information referred to in paragraph 4.33 of the CIRA Guide. Auditors should also refer to and comply with the requirements of AU section 558.07, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1). Specifically, as stated in paragraph 7.59 of the CIRA Guide, procedures that the auditor should consider include the following:

- Determine by physical inspection of the property or review of the CIRA's legal or governing documents whether the disclosure includes all major property components.
- Compare estimates of the costs of major repairs and replacements with current period expenditures and with the annual budget, if any.
- Inquire of management about whether the CIRA's property maintenance records, which reflect each component's replacement history, if any, were considered in determining the information to be disclosed.
- Inquire of management about whether the age and condition of the components were considered in determining the information and amounts to be disclosed.
- Check the mathematical accuracy of amounts disclosed.
- Inquire of management about whether the study was prepared by the board or a professional engineer (reserve specialist [RS]) and whether the methods and bases for estimating the amounts disclosed are documented. Consider whether those methods and bases are reasonable. If the study was conducted by the board, consider whether the source of the information used to estimate the useful lives and current or future repair and replacement costs, for example, bids from contractors or technical manuals on useful lives of various components, are reasonable. Also, the auditor may consider determining whether or not the preparer has their RS designation as a way of confirming that the study was completed in conformance with the National Reserve Study Standards which are referenced in Chapter 3 of the CIRA Guide.
- Inquire if interest is a factor in the reserve study. If it is the auditor should ensure that the interest is retained in the remaining replacement fund.
- Inquire if inflation is a factor in the reserve study. If it is *not* the auditor should recommend an annual review of the replacement costs.
- Inquire of management as to the age of the study.

Audit and Attestation Issues and Developments

Specific Audit Considerations

.49 As the residential real estate market continues to cool, auditors of CIRAs must be conscious of the various financial impacts a cooldown may have on the CIRA's financial situation.

.50 For those CIRAs still under declarant control, the auditor should determine whether the current annual budget is sufficient to meet all of the CIRA's operating needs and still provide for the future replacement of its common elements. The annual budget should be reviewed and compared to the services that the CIRA is currently receiving as stated in paragraph 5.04 of the CIRA Guide regarding the budget process. A declarant of a CIRA may try to continue to operate under a budget which is not adequate so that it will not have to raise the maintenance assessments, which could result in a reduction in sales of units.

.51 The notes to a CIRA's financial statements should include the following disclosures:

- The number of units (shares for cooperative housing corporations and weeks for time-share associations) owned by the developer as stated in paragraph 4.22 of the CIRA Guide.

- The developer or other parties may provide the CIRA with some of its revenues. If 10 percent or more of a CIRA's revenues are derived from any one source, that fact and the amount of revenue from each source should be disclosed as stated in paragraph 4.25 of the CIRA Guide.
- Whether the CIRA's board of directors is controlled by the developer (declarant) as stated in paragraph 7.20 of the CIRA Guide.

.52 The auditor engaged by a CIRA should consider the effects, if any, of the declarant's influence on the CIRA's financial condition as discussed in paragraph 1.26 of the CIRA Guide.

.53 The auditor should make sure that the boards of all CIRAs carefully monitor their cash disbursements by reviewing all invoices to ensure that all expenses incurred by the CIRAs are for valid expenses of the CIRA and not those of the declarant or any one else that may be seeking unapproved personal payments.

.54 The auditor of a CIRA which utilizes a CIRA board that is managed by an outside management company should consider having the board approve all invoices prior to their being processed for payment, which may be more reasonable for unusual, nonrecurring types of expenses. If a management company manages similar-named entities or multiple communities at a similar location, the CIRA board should have a policy instituted to carefully review the invoices noting the date of the service, the service provided, the location of the service, and the quantity, if it is on a per unit or some other type of quantified basis. The auditor should consider the instituted policy and the extent to which the board of directors monitors and controls the managing agents' activities related to the CIRA to insure proper authorization and payment procedures. Since the managing agent provides the CIRA with bookkeeping and accounting services, the auditor should consider AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1), which 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 organizations. When the CIRA uses a managing agent during less than favorable economic times the auditor may also consider the following as discussed in paragraph 7.17 of the CIRA Guide:

- The manner in which the managing agent is compensated, such as the use of fixed fees or otherwise.
- Whether the CIRA maintains separate records for transactions initiated by the managing agent, if any.
- The policy or board review of managing agent reports.
- The control program used by the agent with respect to its client, the association.

.55 The auditor of a CIRA should recommend that the CIRA board review on a monthly basis the budget versus actual financial statements and balance sheet. Since the operations of most CIRAs are based on budgets, the auditor may consider a CIRA's budgeting procedures during the audit. AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1), 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. The auditor should consider comparing actual results with budgeted amounts and investigating significant variances as an analytical procedure in the audit of a CIRA. It is preferred that these statements be prepared on an accrual basis following generally accepted accounting principles (GAAP), however, if the board agrees, the cash method, which is not in conformity with GAAP, can be used. Readers should refer to SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623), as amended, for guidance on auditors' reports on financial statements prepared on a comprehensive basis of accounting other than GAAP. Note that it is not unusual for the monthly financial statements to be prepared on the cash or modified cash basis, and converted to accrual basis at the end of the year. The budget should be seasonalized so the proper expenses appear in the proper period and all major variances should be investigated. The maintenance assessments (more commonly referred to as just "assessment") delinquency report should be monitored carefully as there may be increasing delinquencies if the economy weakens.

Initial Operating Period

.56 During the startup of operations of a condominium or homeowners association, the developer has a majority of the members of the board of directors, and therefore, the CIRA is considered to be under developer control. An auditor engaged by a CIRA should consider the effects, if any, of the declarant's influence on the CIRA's financial condition during the initial operating period in which the developer (declarant) generally controls the CIRA's management, policy setting, and finances. (The initial operating period is discussed further in paragraph 7.20 of the CIRA Guide.) Since the interests of the developer and the homeowners may be divergent, this period of the CIRA's life deserves special attention.

.57 In Florida, for example, the condominium statutes require that after turnover of control an audit must be conducted covering the period from the association's inception through the date of turnover. If none of the fiscal years during the developer-controlled period have been audited, the full cost of such an audit must be borne by the developer. (Readers should refer to state statutes on developer transition with respect to homeowners associations that are not condominiums.) The auditor should keep in mind that, although the developer may pay for the audit, the CIRA is nevertheless the client. Therefore, since the developer's interests may be adverse to those of the CIRA, the auditor should take into consideration that the developer is in control in addressing the risk factors. For example, auditors should consider focusing in on the following areas of an initial operating period:

1. Developer assessments on unsold units.
2. Expenses, particularly in connection with potential payment of developer's obligations.
3. If the developer is guaranteeing that the common expenses will not exceed amounts assessed to unit owners other than the developer, care should be exercised as to the following:
   a. The determination of the proper expiration date of the deficit guarantee period.
   b. The calculation of assessments to unit owners other than the developer.
   c. The proper cutoff of accounts payable and accrued expenses at the end of the deficit guarantee period.
   d. That the rate of assessment is unchanged during the deficit guarantee period.
4. Whether there is a proper utilization, in accordance with the state statutes and condominium documents, of capital contributions collected from initial unit owners.
5. Whether funding for capital replacement and deferred maintenance ("reserves") have been properly funded, or, if funding was waived, that the waiver complied with the state statutes or the CIRA's governing documents.
6. Related party transactions, for example a master association under developer control, or management and maintenance companies owned by the developer.

.58 When making the selection of auditors to conduct the "turnover" audit, oftentimes the developer selects the same accounting firm that services the developer. Although there may not be any independence rulings prohibiting that accounting firm from accepting the CIRA as a client, the accounting firm should evaluate whether there will be any questions of perceived lack of independence. A member of the AICPA who is engaged to audit a CIRA in accordance with generally accepted auditing standards (GAAS) must be independent. In making a judgment about whether he or she is independent, the member should be guided by Rule 101, *Independence*, of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101), its interpretations, and the Ethics Rulings under it.[1] In assessing their independence, auditors

[1] Revised Ethics Ruling No. 31 under Rule 101, "Performance of Services for Common Interest Realty Associations (CIRAs), Including Cooperatives, Condominium Associations, Planned Unit Developments, Homeowners Associations, and Timeshare Developments" (AICPA, *Professional Standards*, vol. 2, ET sec. 191.061–.062), states that an auditor's independence would not be considered to be impaired if certain conditions are met with respect to an engagement to perform services for a CIRA if the member or member's firm is associated with, or is a member of, the CIRA as the result of ownership or lease of real estate.

should also consider the guidance set forth under Ethics Ruling No. 31 under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 191.061–.062). Also, auditors performing audits of CIRAs should be familiar with condominium, homeowners association, and cooperative housing corporation's statutes in the states and/or jurisdictions in which the CIRA is located.

.59 For instance, under Florida statutes, the turnover audit must include the following procedure: "The auditor performing the audit shall examine to the extent necessary supporting documents and records, including the cash disbursements and related paid invoices to determine if expenditures were for CIRA purposes and the billings, cash receipts, and related records to determine that the developer was charged and paid the proper amounts of assessments."

.60 After the turnover audit is released, boards of directors, now controlled by unit owners other than the developer, frequently engage another accounting firm to evaluate the turnover audit. Procedures for this evaluation can be agreed upon with the board, and an engagement letter entered into in accordance with agreed upon procedures set forth in the AICPA attestation standards, AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1). The accountant applying agreed-upon procedures should obtain evidential matter from applying agreed-upon procedures to provide a reasonable basis for the finding or findings expressed in his or her report (AICPA, *Professional Standards*, vol. 1, AT sec. 201.16). Examples of some procedures that the accountant may consider are as follows:

1. Ascertain whether the charges to the developer (assessments and/or deficit contributions) are in compliance with the CIRA's documents and the state statutes.
2. Obtain or prepare a summary of the components comprising the amount due from (to) the developer.
3. Ascertain whether the predecessor auditor performed procedures to determine if any CIRA disbursements were for developer-related obligations. If not, perform such procedures.
4. Determine if capital contributions were received on all initial unit purchases and whether such funds were utilized for their intended purposes.
5. Determine if amounts for future major repairs and replacements ("reserves") were properly funded or waived.

.61 Other considerations for accountants during the initial operating period and for the periods thereafter include:

1. Numbers of units that are in control of the developer or other groups. Readers should refer to paragraph 4.22 of the CIRA Guide for related disclosures.
2. Instances where maintenance fees are kept artificially low in order to induce sales. In such cases, how will the CIRA make up for prior deficits, while at the same time, be able to fund the CIRA's future operations at a significantly higher assessment level?
3. Developers often have their associations enter into lease arrangements for office and maintenance equipment. Such leases could be capital in nature. In those cases, the accountant should raise the question as to whether those assets should be expensed as they generally are under prevalent industry practice, as noted in paragraphs 2.08 through 2.10 of the CIRA Guide.

.62 During a period in which many CIRAs have suffered significant casualty losses from natural disasters, the boards need to address the responsibilities of the developer for funding shortfalls in insurance proceeds. The auditor should consider whether a CIRA's insurance coverage complies with statutory or other documentary requirements.

Special Audit Issue Related to Mixed-Use Projects

.63 Expense allocations between the various members and unit types of a CIRA that are in a mixed-use project must be carefully considered during the audit process. The auditor should consider the appropriate auditing procedures to determine if the expenses are being properly allocated on a reasonable and consistent basis. The expenses should be allocated in compliance with the CIRA's governing documents and the budget included in the offering statement. Furthermore the expense allocations may affect the surplus/deficit for a particular member and unit type and therefore future maintenance assessments for the different members and unit types. Audit procedures applied to assessment revenues should include testing whether amounts assessed to individual owners have been computed in accordance with the CIRA's documents.

Interest Rate Risk for CIRAs That Borrowed Money a Few Years Ago

.64 Banks have found a lending niche in the CIRA market. In the past few years, there has been an increase in associations taking out large dollar amount loans for major repair and replacement projects. The terms of those loans vary; however, quite often, the interest rates are adjustable. Some of these loans were originally taken out several years ago when interest rates were much lower than they are currently. For these adjustable rate loans, payments periodically adjust to market rates. This may occur as often as quarterly or annually, while other loans adjust after three to five years. If the association has a loan that is several years old and is just now adjusting, the association will be making a much larger loan payment, and the impact may be as much as 25 percent to 30 percent higher.

.65 The loans are generally secured by future assessments. If the association has included the loan payment as part of its annual budget and increased the members' assessments, these loan increases will have to be part of the annual budgeting process. The association needs to look into the future budgeting period to determine when the adjustment will take place and estimate the impact on the budget.

.66 If the loan payment is secured by special assessments from the members, those special assessment amounts will need to be adjusted according to the rate increase. Quite often, the members are given the option of paying the special assessment in full at the time of the loan, at the time of resale of their unit, or at any chosen time. Those payments that were received for payment of their portion of the special assessment should have been applied to the principal of the loan, leaving a loan balance that approximates the remaining receivable balances. Thus, only those homeowners who chose to finance their portion of the special assessment will be affected by the interest rate increase. The overall affect of this may be that these owners are also affected by rate increases in their own home mortgages and may be more at risk for default. If the association is unable to collect that portion of the special assessment, due to bankruptcy or foreclosure of the unit, the amount of the remaining loan payment will have to be paid from the general budget. Also, if the association was neglectful and did not pay down the loan as special assessment payoffs were received, the association will be affected by the increased loan payment for the shortfall between what is being received by the remaining owners and the actual payment amount.

Bad Debt Allowances

.67 Housing prices showed annualized double-digit gains for the last three years. Due to these increases in real estate prices, most accountants have seen minimal bad debt write-offs as there has been "built in" equity in a unit, even just a few months after the purchase of a unit, due to the economy. Thus, if the association has been diligent in its collection measures and has filed liens and foreclosures, they have been able to collect the past due assessments, fees, and charges. Most housing markets in many areas of the country are now seeing a leveling off, or at the most a slight increase or slight decrease, in housing prices. Predictions are for this flattening off to continue through 2006 and 2007.

.68 Added to this issue is the fact that there has been an increase in adjustable rate and nonconforming mortgages used by owners to purchase their homes. In the climate of increased interest rates, as those loan payments are adjusted to the current rates, some homeowners will find payment of the monthly mortgage payment difficult. Roughly $137.5 billion in residential mortgages will face payment resets in 2006 and another $524 billion will reset in the next four years (according to an analysis by the Union Bank of Switzerland, UBS AG). These loans are found in all income brackets.

.69 With the softening of the housing market in some areas, and the increased home mortgage payments, it is probable that write-off of assessments to bad debt will increase in the future. It is the auditor's job to determine whether management's estimate of the allowance for bad debts is reasonable. Auditors should follow AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), which provides guidance on obtaining and evaluating sufficient, competent evidential matter in support of accounting estimates included in the financial statements. The bad debts should be presented in the statement of revenues and expenses which presents information about all assessments, other revenues, and expenses.

.70 Management must make careful judgments about collectibility and estimates of allowances for bad debts. In the current economic climate, you cannot use prior history as a model for analysis. Some management companies and boards of directors do not understand the requirement for the allowance and may not want "bad debts" on their financial statements. The auditor needs to educate them in the importance of not overstating assets or revenues by including receivables or assessment income that is uncollectible.

Ensuring Management Has Expertise to Accept Adjusting Journal Entries

.71 The accountant's definition of "management" includes those within an organization who have some type of responsibility with regards to the proper presentation of the financial statements. The auditor would generally include in that definition paid management (such as a portfolio manager or on-site manager), as well as the board of directors.

.72 For non-accountants within the CIRA industry, the definition of "management" is generally more strictly defined to mean paid management. The auditor needs to ensure that the board of directors understands that they are included in this definition and, in fact, are the primary members of the "management" team.

.73 AU section 333.03, *Management Representations* (AICPA, *Professional Standards*, vol. 1), states that during an audit, management makes many representations to the auditor, both oral and written, in response to specific inquiries or through the financial statements. 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. 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.

.74 Written representations from management should be obtained 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.

.75 The representation letter ordinarily should be tailored to include additional appropriate representations from management relating to matters specific to the entity's business or industry. AU section 333.17 (Appendix B, "Additional Illustrative Representations") provides examples of additional representations that may be appropriate. Also see Appendix B of the CIRA Guide for illustrative representation letters. Generally the representation letter is signed by representatives from paid management and the board of directors.

.76 Practitioners must assure themselves that management is taking responsibility for the adjusting journal entries presented at the time of the year end engagement. Auditors may consider as a good practice including the following representation in the letter signed by management, as illustrated in the representation letter found in Appendix F, "Review of Financial Statements—Illustrative Representation Letter," of AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 100.79).

We are in agreement with the adjusting journal entries you have recommended, and they have been posted to the company's accounts. (if applicable)

.77 In many instances, the CIRA's accounting department may not be sufficiently sophisticated to understand accrual adjustments. Also, the CIRA may be run by a volunteer board of directors with little or no financial expertise. Even professional managers may not have a proficiency in accounting matters.

.78 While the client does not have to be a financial expert, the practitioner must be able to assure himself or herself that the client has some rudimentary understanding of the adjustments and their impact on the financial statements. Identifying the person(s) and educating that (those) person(s) during the year end audit or review should be part of the accountant's planning process.

.79 In instances in which a management company prepares the CIRA's financial statements, the auditor should consider having a representative of the management company (for example, controller, association accountant, or its equivalent) sign the representation letter. Frequently, the management company will limit its representations to certain items. The auditor should assess the adequacy of these representations (which may have been agreed upon with the management company in advance).

.80 In obtaining representations in connection with a turnover audit, the auditor should consider the representations of each of the boards of directors, both prior to and after the turnover. Of course, the periods of time to which the representations apply should be indicated on the letter.

The Importance of Performing Monthly Bank Reconciliations and Fraud

.81 Discovering one type of fraudulent scheme before more monies are stolen can be halted by management performing monthly bank reconciliations on a timely basis. A fairly simple accounting function can provide good controls if done on a consistent basis. One such fraud committed against an association would be where the perpetrators forged checks by gaining unlawful access to a "real" check from the association and then duplicating that information onto blank check stock.

.82 The simple lesson is that associations need to be diligent in performing monthly bank reconciliations in a timely manner. This fraud was not found by the bank, but by the manager at the time of the reconciliation. Many associations do not reconcile their bank accounts for months resulting in greater difficulty tracing and more monies stolen.

.83 Other examples of recent frauds committed against CIRAs:

- Altering association records relating to costs and presenting false work reports to the board.
- At one Upper East Side New York cooperative, $4.7 million was repaid, but the looting of its funds by a trusted treasurer offers lessons for all co-ops and their volunteer boards.
- Manager, in conjunction with husband, who was a printer by trade, produces almost perfect bank statements used to loot the reserves. "Almost" perfect because the husband forgot to include the watermark which can be added with most software programs.
- Manager is allowed discretion with expenses under $1,000. Manager has associations with busy financials. The manager has work done on personal residence, splitting invoices on that residence (with the unwitting aid of vendors) into increments of less than $1,000.
- Manager in a cold climate has utility bills placed on a payment plan, but bills the association with the real-time usage and pockets the difference.

- Manager in a resort environment has work performed on personal residence by association staff during slow time.
- Maintenance staff person, with part-time duty of showing vacant units for owners and for association-owned units, rents the units (short term) and keeps the rents.

.84 Most such losses never get reported to anyone—the police, the owners, the fidelity insurers, and so on—because the board does not want the adverse publicity.

.85 Readers should be aware that for any of the above examples the CIRA has to demonstrate the perpetrator's "manifest intent" to cause harm in order to obtain recovery from the fidelity insurer.

Practice Implications Related to the Revisions Made by SAS No. 112

.86 In May 2006, the AICPA Auditing Standards Board (ASB) issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006.

How the Revisions Will Affect Practice

.87 As you gain a better understanding of what needs to be communicated to management and those charged with governance, you may find that there will be more control deficiencies that you:

- Identify as significant deficiencies and material weaknesses, and
- Communicate to management and those charged with governance.

You may emphasize and therefore spend more time evaluating identified control deficiencies than you did in the past.

.88 ***Discussions With Management and Others***. The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. You may have to explain to your clients that you, the auditor, *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.89 You may wish to be called upon to hold discussions with management and other users of your written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the definitions have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of *material weaknesses*. Another reason is that you have to include significant deficiencies and material weaknesses identified and communicated in previous years in your written communication as long as these deficiencies have not been remediated. You may need to explain to management and other users that you are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.90 You may also need to hold discussions with management and other users who ask how you were able to express a clean opinion on the financial statements when material weaknesses in internal control were present. You may wish to explain that your audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control. You can express a clean opinion on the financial statements even though material weaknesses in internal control are present, because you performed sufficient procedures and obtained appropriate audit evidence to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented or detected by the client.

Issues for Audits of Smaller Entities

.91 One issue that may arise in audits of smaller entities is the possibility of increased costs as a result of the auditor time spent documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.92 Another issue that may cause concern is the extent to which you (as the auditor) may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if your client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing or detecting material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, since doing so would impair independence.[2] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a control weakness by assisting in drafting the financial statements does not change the control weakness.

.93 ***Possible Opportunities.*** The new requirements of SAS No. 112 introduce possible opportunities for you. You can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. You can also teach your clients how to develop a risk assessment approach to designing internal control.

> **Help Desk**—See the AICPA Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies—A Companion to SAS No. 112* (product no. 022536kk) for a thorough discussion of SAS No. 112.

Audit Documentation

.94 In December 2005, the AICPA ASB issued SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339). SAS No. 103 supersedes SAS No. 96, *Audit Documentation*, and amends SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 530, "Dating of the Independent Auditor's Report"), as amended. SAS No. 103 establishes standards and provides guidance to auditors of nonissuers on audit documentation. The auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed); the audit evidence obtained and its source; and the conclusions reached. Audit documentation:

1. Provides the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with generally accepted auditing standards (GAAS).
2. Provides the principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

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[2] See Ethics Ruling 101-3, "Performance of Nonattest Services," of AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

.95 Audit documentation is an essential element of audit quality. Although documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate documentation contributes to the quality of an audit.

.96 Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions the auditor reached. Audit documentation, also known as working papers or workpapers, may be recorded on paper or on electronic or other media. When transferring or copying paper documentation to another media, the auditor should apply procedures to generate a copy that is faithful in form and content to the original paper document.[3]

.97 Audit documentation includes, for example, audit programs,[4] analyses, issues memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail) concerning significant findings or issues, and schedules of the work the auditor performed. Abstracts or copies of the organization's records (for example, significant and specific contracts and agreements) should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. The audit documentation for a specific engagement is assembled in an audit file.[5]

.98 The auditor need not retain in audit documentation superseded drafts of working papers or financial statements, notes that reflect incomplete or preliminary thinking, previous copies of documents corrected for typographical or other errors, and duplicates of documents.

In addition to the objectives set out in paragraph 3 of SAS No. 103, audit documentation serves a number of other purposes, including:

- Assisting the audit team to plan and perform the audit;
- Assisting auditors who are new to an engagement by being able to review the prior year's documentation, allowing them to understand the work performed as an aid in planning and performing the current engagement;
- Assisting members of the audit team responsible for supervision to direct and supervise the audit work, and to review the quality of work performed;
- Demonstrating the accountability of the audit team for its work by documenting the procedures performed, the audit evidence examined, and the conclusions reached;
- Retaining a record of matters of continuing significance to future audits of the same organization;
- Assisting quality control reviewers (for example, internal inspectors) who review documentation to understand how the engagement team reached significant conclusions and whether there is adequate evidential support for those conclusions;
- Enabling an experienced auditor to conduct inspections or peer reviews in accordance with applicable legal, regulatory, or other requirements; and
- Assisting a successor auditor who reviews a predecessor auditor's audit documentation.

.99 For the purposes of SAS No. 103, *experienced auditor* means an individual (whether internal or external to the firm) who possesses the competencies and skills that would have enabled him or her to perform the

[3] There may be legal, regulatory, or other reasons to retain the original paper document.

[4] See Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A.05), as amended, for guidance regarding preparation of audit programs.

[5] The audit documentation contained within the audit file may consist of cross-references to documentation for audit engagements with related entities.

audit. These competencies and skills include an understanding of (1) audit processes, (2) the SASs and applicable legal and regulatory requirements, (3) the business environment in which the entity operates, and (4) auditing and financial reporting issues relevant to the organization's industry.

.100 SAS No. 103 provides guidance on the form, content, and extent of audit documentation. It also discusses how to document significant findings or issues including documenting audit evidence that is identified as being contradictory or inconsistent with the final conclusions, and how the auditor addressed the contradiction or inconsistency. This SAS requires the identification of the preparer and reviewer of the audit work. In addition, it provides guidance on audit documentation of the specific items tested, documentation if there is a departure from a SAS, revisions to audit documentation made after the date of the auditor's report, and the ownership and confidentiality of audit documentation. See SAS No. 103 for specific guidance.

.101 Another key provision of this standard is the amendment of paragraphs .01 and .05 of AU section 530. AU section 530.01 now requires that "the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion" and the footnote to this paragraph describes sufficient appropriate audit evidence as "evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them." Application of the rules may require revising the process used by your firm at the end of fieldwork to include a field review of audit workpapers and financial statements. For some firms an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.102 Furthermore, the auditor should complete the assembly of the final audit file on a timely basis, but within 60 days following the report release date (documentation completion date). Statutes, regulations, or the audit firm's quality control policies may specify a shorter period of time in which this assembly process should be completed.

Retention of Working Papers

.103 SAS No. 103 says that the auditor should adopt reasonable procedures to retain and access 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. Such retention period, however, should not be shorter than five years from the report release date. Statutes, regulations, or the audit firm's quality control policies may specify a longer retention period.

The SAS is effective for audits of financial statements for periods ending on or after December 15, 2006.

Accounting Issues and Developments

CIRA Note Disclosures

.104 Many CIRAs rely on the accountant for guidance in the preparation of the financial statements. The financial statements should include any disclosures that would be appropriate to assist the reader to better understand them. The homeowners, who are the ultimate users of the financial statements, quite often have their biggest investments in their homes within the association. However, in most instances, these "investors" do not know how to read the financial statements. Note disclosures can assist in overcoming this hurdle.

Mold Remediation Disclosure

.105 When mold is found and remediated within an association, the total financial impact may be unknown for various reasons. First, there may be little or no insurance coverage for the event. Next, the association may not have a clear policy as to the association's responsibility versus the homeowner. Last, it is a hidden problem, so the extent is not known until exposed or a period of time passes. Thus, the CPA should consider including some type of contingency note to the financial statements explaining that the condition exists, remediation is (or is not) ongoing, and that the total financial impact cannot be determined at this time.

.106 Auditors should review the minutes from the board of directors meetings for such matters as approvals for mold remediation expenditures. Also, review of large unusual repair expenses or replacement fund expenses can uncover mold remediation. Furthermore, the auditor should consider whether the CIRA's insurance coverage complies with statutory or other documentary requirements. Although Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies,* does not require the disclosure of noninsured or underinsured risks, it states specifically that it does not discourage such disclosures.

Related Party Transactions Disclosure

.107 The most common related party transactions in CIRAs involve the developer or management companies. Developer transactions are easy to find and research, as it is general knowledge when a developer is still involved with the association. However, when a management company performs duties outside the basic management contract it may not be readily known. Care needs to be taken by the accountant to inquire as to whether the management company or board of directors (and their immediate families) provides goods and services to the association. Examples include the following:

- A board member is the broker at the brokerage firm in charge of the association's investments.
- A board member is the association's insurance agent.
- The management company has a separate landscape company (sometimes under a different name) that services the association.

.108 Such services may require disclosure in conformity with FASB Statement No. 57, *Related Party Disclosures.* If the related party transactions mentioned above exist, there is a requirement to disclose such transactions to the membership. The accountant may also want to inquire if the conflict of interest was disclosed to the membership at the time the contract was entered into and if proper conflict-of-interest procedures were followed, such as the board member abstaining from voting on the contract. Additionally, when a related party is involved the CIRA should exercise due diligence by getting other bids or reviewing the contract on an annual basis.

.109 CIRAs often enter into agreements or contracts with agents or others not directly managed by the CIRA to provide services to unit owners, such as operation of recreational facilities or garages. The auditor may find it necessary to review provisions of such contracts or agreements and consider whether the board was authorized to enter into the contracts and transactions pursuant to the contracts and whether related account balances are appropriately recorded and disclosed in the financial statements. The auditor should also consider whether commitments for long-term contracts have been disclosed when appropriate.

.110 The auditor should refer to the guidance in AU section 334, *Related Parties* (AICPA, *Professional Standards*, vol. 1), to determine the existence of related-party relationships and transactions with such parties as some individual board members, officers, or developers which may provide CIRAs with insurance, maintenance, or management services. For example, the auditor of a CIRA may consider recommending that the CIRA board have each member sign a document stating that neither they, their immediate family, nor any other lineal ancestor, has an ownership interest in any entity which provides a service to the CIRA, other than those vendors which are disclosed on the signed form. This procedure would help document all related parties and inform all board members of such related parties. Additional procedures such as having the board member abstain from voting on a contract with a related party or using a closed bid process may also be considered.

.111 Furthermore, AU section 334 states that, in auditing related-party transactions that are identified during the course of the audit, the independent accountant should be aware that the substance of a particular transaction could be significantly different from its form and that financial statements should recognize the substance of particular transactions rather than merely their legal form. Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or, assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a related-party transaction was consummated on terms equivalent to those that prevail in arm's-length transactions.

Special Assessment Disclosures

.112 Special assessments are enacted for a variety of reasons with a variety of repayment plans. The footnotes should adequately explain the reason for the special assessment, the timing of the assessment and the repayment terms. Also, the summary of significant accounting policies should include the special assessments revenue recognition policy. At the end of the year, the remaining special assessments should be summarized, including the amount of deferred revenue.

.113 Below are a few examples of special assessment disclosures:

> The Association established three special assessments in a prior year. Beginning February 1, 2001, there was a special assessment of $4,892.24 per unit which could be paid at the rate of $72.86 per month. The monthly payment amount in 2005 was $62.95. The stated purpose for the assessment was reserves and settlement. Beginning October 1, 2001, there was a special assessment of $3,428.57 per unit which could be paid at the rate of $54.29 per month. The monthly payment amount in 2005 was $46.87. The stated purpose for the assessment was for streets. Beginning February 1, 2002, there was a special assessment of $2,253.86 per unit which could be paid at the rate of $16.85 per month. The monthly payment amount in 2005 was $12.72. The stated purpose for the assessment was for fireplaces. Homeowners were given the option of paying any or all of the assessments in full or paying on a monthly basis over a period of eight years. Monthly payments were to be adjusted to coincide with the prevailing interest rate. This did not occur in 2005. The payments were still at the 2004 interest rate.
>
> In a prior year, the membership approved a special assessment in the amount of $3,100.00 per unit (total $623,100.00) to be used solely for payment of the costs of applying a barrier coating material to the common area potable hot and cold water pipes and related costs. The members had the option of paying the amount in full by September 1, 2003 or paying $60.00 per month for 40 months beginning September 1, 2003. Twenty-five homeowners were making payments at year end.
>
> There was an emergency special assessment in the current year to install caissons and underpinning in one of the buildings due to slope failure. The Association's board of directors received a report from an engineer stating that a building was experiencing serious signs of failure due to slope subsistence. The special assessment was $4,000 per unit for a total of $408,000. The unit owners had the option of making four payments of $1,000 each for the months of July through October 2005. At the end of the year, the outstanding special assessments receivable was approximately $12,000.

.114 As discussed in paragraph 7.53 of the CIRA Guide, when auditing special assessments receivable, the auditor should design tests to provide reasonable assurance that—

- All assessments receivable owed to the CIRA at the balance-sheet date are recorded.
- Recorded assessments receivable represent amounts owed to the CIRA at the balance-sheet date.
- Assessments receivable are properly described and classified in the financial statements.

.115 The auditor may achieve these objectives by performing substantive tests or a combination of substantive tests and tests of control activities. Substantive tests for determining the existence and accuracy of receivables include confirmation of the amount receivable by direct communication with parties owing amounts to the entity being audited and tests of subsequent receipts. SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1, AU sec. 330), provides guidance about the confirmation process in audits performed in accordance with GAAS. If replies to confirmation requests are not received or if the replies are not satisfactory, the auditor should obtain satisfaction about the existence and accuracy of assessment receivable balances by alternative procedures such as examining subsequent cash receipts and the existence of liens filed against units, although such liens do not assure the collectibility of assessments receivable.

.116 In practice, confirming assessments receivable may not be an effective procedure because members generally do not return the confirmation or return inadequate replies, thus requiring alternative procedures. Further, alternative procedures may be the most effective method of substantiating assessments receivable balances because these are normally collected shortly after assessment. The balances that are uncollected normally require the auditor to consult with management, legal counsel, or both regarding collectibility. In accordance with SAS No. 67, auditors who omit confirmation procedures must document the reasons why those procedures were omitted.

Replacement Fund Disclosures

.117 The CIRA Guide gives some examples of the basic replacement fund disclosures. Since the replacement fund is a critical part of the association and is not found in other industries, the accountant should consider whether additional disclosures are appropriate to assist the reader of the financial statements. Some examples include the following:

- The most recent reserve study recommends a special assessment of $X,XXX for each homeowner in the upcoming year. This has/has not been adopted by the board/members.
- The board chose to use replacement fund monies for mold remediation, which is not a component of the reserve study. The reserve study will be re-computed to calculate the impact on future funding.
- The association is X percent funded according to the latest reserve study.
- The association is funding for components with a life of 30 years or less. There are additional components with lives of over 30 years which are not included in this calculation.
- The association budgeted $XX,XXX to be transferred to the replacement fund. No monies were actually deposited into the replacement fund for the year, and the association has no plans on repaying these unfunded amounts.
- In order to save finance charges, the board has chosen to borrow the earthquake insurance premium from the replacement fund. This will be repaid in twelve equal monthly payments from the operating fund. At the end of the year, there were five months remaining for a total of $X,XXX.

.118 If the disclosures about a CIRA's funding for future major repairs and replacements required by paragraph 4.27 of the CIRA Guide are absent or inadequate, the auditor should consider modifying his or her report, as discussed in AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1).

Deficit Equities and Net Losses

.119 In some areas of the country, there is more resistance by boards of directors against increasing their assessments to adequately cover operating expenses and the funding of the replacement fund. This appears to be related to the fact that homeowners' budgets are tightened due to increased mortgage payments, higher fuel prices, and the general debt level of homeowners. Additionally, in associations where the vast majority of owners are on a fixed income, there is the same resistance. Thus, the decision is being made to leave association assessment amounts the same as the prior year, or with a minimal increase. This is not reasonable in relation to the same economic conditions causing association expenses to increase.

.120 Due to lack of knowledge as to how to read a financial statement, boards of directors and managers may not be aware that the association is operating at a loss or that the operating fund (members' equity) is running a deficit balance. This is especially true if monies are being borrowed from reserves so that there is sufficient cash flow to pay the bills, or if the manager or accounting personnel is holding the payments to vendors. This is further enhanced in that the financial statements are prepared on the cash basis of accounting or not on a fund balance which would show the amount due between the funds. Co-ops have significant depreciation so they usually show net operating losses and deficit equity. The test the auditor and financial statement users should make is whether the deficit equity is less than accumulated depreciation. If no, the co-op is in trouble.

.121 In order to function effectively, the board of directors should make a valid attempt to understand the issues associated with CIRA governance and the evolving accounting and auditing regulatory environment. The resources available in the "Improving the Audit Committee" section of the AICPA Web site address these issues, and help audit committee members understand how to develop efficient committee processes and engage in active and effective oversight to achieve financial literacy. Readers may refer the boards of directors of their CIRA clients to www.aicpa.org/audcommctr/homepage.htm for guidance to achieve financial literacy.

.122 The Community Associations Institute (CAI) recommends in its M-206 Financial Management course, which is required to become a Professional Community Association Manager (PCAM), that an association have a minimum of 2 percent to 5 percent of the annual budget as a balance in the operating fund for contingencies, with 10 percent to 15 percent being "very good." CAI considers this to be a good rule of thumb. Additionally, the CAI course recommends one month of operating expenses to be in the operating cash account. These are just recommendations and may differ based on the CIRA's circumstances.

.123 The practitioner may want to consider either meeting with the board of directors or discussing the issue in a management letter to ensure that the board is aware of the current financial condition.

Staff Accounting Bulletin No. 108

.124 On September 13, 2006, the Securities and Exchange Commission (SEC) released Staff Accounting Bulletin (SAB) No. 108, Topic 1N, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements." The issuance provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement.

.125 There have been two common approaches used to quantify such errors. Under one approach, the error is quantified as the amount by which the current year income statement is misstated (rollover approach). The other common approach quantifies the error as the cumulative amount by which the current year balance sheet is misstated (iron curtain approach). Exclusive reliance on an income statement approach can result in a registrant accumulating errors on the balance sheet that may not have been material to any individual income statement, but which nonetheless may misstate one or more balance sheet accounts. Similarly, exclusive reliance on a balance sheet approach can result in a registrant disregarding the effects of errors in the current year income statement that result from the correction of an error existing in previously issued financial statements.

.126 The SEC staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The SEC staff believes that this can be accomplished by quantifying errors under both a balance sheet and an income statement approach and by evaluating errors measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a material misstatement after considering all relevant quantitative and qualitative factors.

.127 If, in correcting an error in the current year, an error is material to the current year's income statement, the prior year financial statements should be corrected, even though such a revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements. However, registrants electing not to restate prior periods should follow the disclosure requirements specified in SAB No. 108. While the guidance outlined in the SAB only specifically applies to public companies and other entities whose financial information is filed with the SEC, non-issuers may also consider this guidance when quantifying financial statement misstatements. In general, SAB No. 108 is effective for financial statements for fiscal years ending after November 15, 2006, with earlier application encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006, and filed after the SAB's publication date of September 13, 2006. For additional accounting and transition information, see the issuance at www.sec.gov/interps/account/sab108.pdf.

Technical Practice Aids on Guidance for Losses From Natural Disasters

.128 The AICPA recently issued an accounting Technical Practice Aid (TPA), section 5400.05, "Accounting and Disclosures Guidance for Losses From Natural Disasters—Nongovernmental Entities," regarding the accounting and disclosures for losses from natural disasters for nongovernmental entities.

.129 In 2005, hurricanes devastated several states along the Gulf Coast of the United States, took many lives, and caused considerable damage to entities. In its effort to provide financial reporting guidance on accounting and disclosures of losses from natural disasters, AICPA staff identified certain accounting issues and provided a road map reference to relevant accounting literature for nongovernmental entities to assist preparers and practitioners. For a more detailed discussion, readers should refer to the TPA at www.aicpa.org/download/acctstd/Natural_disaster_TPA_5400.05.pdf.

.130 The AICPA has also issued the following auditing TPAs in response to the hurricanes. Auditors whose clients are affected by the hurricanes or other natural disasters should follow the guidance in these TPAs, as appropriate.

- TPA section 9070.05, "Consideration of Impact of Losses From Natural Disasters Occurring After Completion of Audit Field Work and Signing of the Auditor's Report But Before Issuance of the Auditor's Report and Related Financial Statements"
- TPA section 8345.01, "Audit Considerations When Client Evidence and Corroborating Evidence in Support of the Financial Statements Has Been Destroyed by Fire, Flood, or Natural Disaster"
- TPA section 8345.02, "Considerations When Audit Documentation Has Been Destroyed by Fire, Flood, or Natural Disaster"

Disaster Response Checklist for CFOs and Controllers

.131 The AICPA has developed a checklist to help financial executives navigate through the complicated task of disaster recovery. When a company faces a disaster, whether it is a local or regional situation, it must address a variety of issues in a timely manner. This checklist helps walk the finance executive through disaster response in a series of phases, outlining issues that need to be addressed to understand damage and minimize ongoing risks, including ensuring employee safety, maintaining operations, and evaluating the company's financial situation. To access the checklist, visit www.aicpa.org/news/2005/disaster_response.htm.

Online Disaster Recovery Resource Center

.132 The AICPA has established a central online Disaster Recovery Resource Center. Visit this site frequently for up-to-date information, useful links to other Web sites, and a wide range of practical tools on this topic. It includes resources for members to use to assist their employers and clients, as well as practice management guidance for firms directly affected by Hurricane Katrina. The site will be updated regularly; check back often.

EITF Issues and FASB Staff Positions

.133 The FASB is very active in issuing Emerging Issues Task Force (EITF) Issues and FASB Staff Positions (FSPs). Auditors should visit the FASB Web site to stay abreast of these many issues and understand those accounting requirements that may pertain to their clients' financial statements. In the AICPA general *Audit Risk Alert—2006/07* you will find a list of selected EITF Issues and FSPs that have been issued recently and have broad interest.

FSP No. FAS 13-1, "Accounting for Rental Costs Incurred during a Construction Period"

.134 Accounting guidance for leasing arrangements is provided in FASB Statement No. 13, *Accounting for Leases*, as amended and interpreted. This FSP was issued in response to questions as to whether lessees can capitalize rental costs associated with ground and building operating leases that are incurred during a construction period. FSP No. FAS 13-1 states that there is no distinction between the right to use a leased asset during the construction period and the right to use that asset after the construction period. Rental costs associated with ground or building operating leases and incurred during a construction period are therefore recognized as rental expense and included in income from continuing operations. FASB Statement No. 13 and FASB Technical Bulletin 85-3, *Accounting for Operating Leases with Scheduled Rent Increases*, provide guidance to determine how to allocate rental costs over the lease term.

.135 FSP No. FAS 13-1 should be applied to the first reporting period beginning after December 15, 2005. Earlier adoption is permitted for financial statements or interim financial statements that have not been issued. Lessees are required to cease capitalizing rental costs as of the effective date of FSP No. FAS 13-1 for operating lease arrangements entered into prior to the FSP's effective date.

Recent Auditing, Attestation, and Quality Control Pronouncements and Related Guidance

.136 Presented below is a list of the most recent auditing, attestation, quality control, and related guidance issued. For information on auditing and attestation standards, quality control standards, and related guidance that may have been issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm.

.137 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's Auditing Standards team and available at www.aicpa.org/members/div/auditstd/opinion/index.htm.

> ***Note:*** SAS No. 104 through No. 111 were issued together and are known as the "risk assessment" standards. They apply to audits conducted in accordance with GAAS.

Statement on Auditing Standards (SAS) No. 114 (November 2006) (Applicable to audits conducted in accordance with GAAS)	*The Auditor's Communication With Those Charged With Governance*
SAS No. 113 (November 2006) (Applicable to audits conducted in accordance with GAAS)	*Omnibus—2006*
SAS No. 112 (May 2006) (Applicable to audits conducted in accordance with GAAS)	*Communicating Internal Control Related Matters Identified in an Audit*
SAS No. 111 (March 2006) (Applicable to audits conducted in accordance with GAAS)	*Amendment to Statement on Auditing Standards No. 39,* Audit Sampling
SAS No. 110 (March 2006) (Applicable to audits conducted in accordance with GAAS)	*Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
SAS No. 109 (March 2006) (Applicable to audits conducted in accordance with GAAS)	*Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
SAS No. 108 (March 2006) (Applicable to audits conducted in accordance with GAAS)	*Planning and Supervision*
SAS No. 107 (March 2006) (Applicable to audits conducted in accordance with GAAS)	*Audit Risk and Materiality in Conducting an Audit*

(continued)

SAS No. 106 (March 2006) (Applicable to audits conducted in accordance with GAAS)	*Audit Evidence*
SAS No. 105 (March 2006) (Applicable to audits conducted in accordance with GAAS)	*Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards
SAS No. 104 (March 2006) (Applicable to audits conducted in accordance with GAAS)	*Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*
SAS No. 103 (December 2005) (Applicable to audits conducted in accordance with GAAS)	*Audit Documentation*. This SAS supersedes SAS No. 96 of the same name. This SAS establishes standards and provides guidance to an auditor of a nonissuer on audit documentation. Audit documentation is an essential element of audit quality. Although audit documentation alone does not guarantee audit quality, the process of preparing sufficient and appropriate audit documentation contributes to the quality of an audit.
SAS No. 102 and Statement on Standards for Attestation Engagements (SSAE) No. 13 (December 2005) (Applicable to audits conducted in accordance with GAAS)	*Defining Professional Requirements in Statements on Auditing Standards* and *Defining Professional Requirements in Statements on Standards for Attestation Engagements* These Statements define the terminology the ASB will use to describe the degrees of responsibility that the requirements impose on the auditor or the practitioner.
AICPA Auditing Interpretation No. 1 of AU section 328, *Auditing Fair Value Measurements and Disclosures* and AICPA Auditing Interpretation No. 1 of AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*	"Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value" and "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist" These Interpretations clarify that simply receiving a confirmation from a third party (including a trustee) does not in and of itself constitute adequate audit evidence with respect to the valuation assertion of interests in trusts or investments in securities. The Interpretations also reiterate the responsibility of management to institute accounting and financial reporting processes for the determination of fair value measurements. According to the Interpretations, if the auditor is unable to *(continued)*

(July 2005) (Applicable to audits conducted in accordance with GAAS)	audit the existence or measurement of interests in investments in securities at the financial statement date, the auditor should consider whether that scope limitation requires the auditor to qualify his or her opinion or disclaim an opinion.
AICPA Technical Practice Aid 9070.05 (August 2005) (nonauthoritative)	"Consideration of Impact of Losses From Natural Disasters Occurring After Completion of Audit Field Work and Signing of the Auditor's Report But Before Issuance of the Auditor's Report and Related Financial Statements"
AICPA Technical Practice Aid 8345.01 (September 2005) (nonauthoritative)	"Audit Considerations When Client Evidence and Corroborating Evidence in Support of the Financial Statements Has Been Destroyed by Fire, Flood, or Natural Disaster"
AICPA Technical Practice Aid 8345.02 (September 2005) (nonauthoritative)	"Considerations When Audit Documentation Has Been Destroyed by Fire, Flood, or Natural Disaster"
AICPA Practice Alert 2005-1 (September 2005) (nonauthoritative)	*Auditing Procedures With Respect to Variable Interest Entities* The purpose of this Practice Alert is to provide guidance to auditors in planning and performing auditing procedures with respect to variable interest entities.
AICPA Audit and Accounting Practice Aid (nonauthoritative)	*SAS No. 70 Reports and Employee Benefit Plans* This publication provides guidance on the use of SAS No. 70 reports in audits performed in accordance with GAAS. In addition, this publication includes checklists and forms to help implement the guidance.
Guidance on Management Override of Internal Controls (nonauthoritative)	*Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention? The Audit Committee and Oversight of Financial Reporting* This guidance is available through the AICPA Audit Committee Effectiveness Center at www.aicpa.org/audcommctr (go to "Spotlight Area").

.138 As necessary, auditors should obtain and understand the complete text of the applicable standards and other guidance. You should visit the applicable Web site for complete information.

Auditing Standards Available on AICPA Web Site

.139 The standards and interpretations promulgated by the AICPA ASB are available free of charge by visiting the AICPA Audit and Attest Standards Team's page at www.aicpa.org/members/div/auditstd/Auth_Lit_for_NonIssuers.htm. Members and nonmembers alike can download the auditing, attestation, and quality control standards by either choosing a section of the codification or an individual statement number. You can also obtain copies of AICPA standards and other guidance by contacting the AICPA at (888) 777-7077 or online at www.cpa2biz.com.

Recent AICPA Independence and Ethics Pronouncements

.140 The AICPA *Independence and Ethics Alert—2006/07* (product no. 022477kk) contains a complete update on new independence and ethics pronouncements. This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this Alert to be aware of independence and ethics matters that will affect their practice.

.141 In addition to the other matters discussed in *Independence and Ethics Alert—2006/07*, auditors should be aware of these recent issuances by the AICPA Professional Ethics Executive Committee (PEEC):

- Revised Interpretation No. 501-1, "Retention of Clients Records" (AICPA, *Professional Standards*, vol. 2, ET sec. 501.02), to provide guidance to members on their ethical responsibilities when a client or former client makes a request for client records, supporting records, or other documents that are in the custody or control of the member. The revised interpretation defines key terms and requires that client provided records be returned to the client upon request but that client records prepared by the member and supporting records may be withheld if the engagement is incomplete or there are fees due to the member for the specific engagement. In addition, the committee has deleted Ethics Rulings No. 182 of ET section 591, "Ethics Rulings on Other Responsibilities and Practices" (AICPA, *Professional Standards*, vol. 2, ET sec. 591.363–.364), because the substance of this ethics ruling has been incorporated into the revised Interpretation No. 501-1.
- New Interpretation No. 101-15, "Financial Relationships" (AICPA, *Professional Standards*, vol. 2, ET sec. 101.17), defines financial interest, direct financial interest, and indirect financial interest as used in Interpretation No. 101-1, and provides guidance to members in determining whether financial interests should be considered direct or indirect financial interests. Readers should refer to the AICPA Web site at www.aicpa.org/download/ethics/interp101_1.pdf for further information.
- Ethics Rulings No. 113, "Acceptance or Offering of Gifts or Entertainment," and No. 114, "Acceptance or Offering of Gifts and Entertainment to or From an Attest Client," under Rule 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.226–.227 and 191.228–.229, respectively), provide guidance on how a member's offer or acceptance of gifts or entertainment, to or from a client (both attest and nonattest), or a customer or vendor of the member's employer, affects a member's independence or objectivity. Readers should refer to the AICPA Web site at www.aicpa.org/download/ethics/Gifts_and_Entertainment_Rulings.pdf for further information.
- The PEEC has approved the release of "Conceptual Framework for AICPA Independence Standards" (AICPA, *Professional Standards*, ET sec. 100.01), and a related revision to "Other Considerations" of Interpretation No. 101-1, "Interpretation of Rule 101" (AICPA, *Professional Standards*, ET sec. 101.02) of the Code of Professional Conduct. Readers should refer to the AICPA Web site at www.aicpa.org/download/ethics/Ethics_Interpretation_101-1_and_Conceptual_Framework.pdf for further information, including the effective date.

.142 Readers should be aware of the following guidance on understanding and implementing Interpretation No. 101-3:

- Interpretation No. 101-3, "Performance of Nonattest Services" (as revised and adopted on January 27, 2005), can be found online at www.aicpa.org/members/div/ethics/intr_101-3.htm.
- *AICPA Interpretation 101-3, Performance of Nonattest Services—Understanding General Requirement No. 2: Client Responsibilities* provides detailed answers to the most frequently asked questions regarding this important provision of Interpretation No. 101-3. Topics covered include what is meant by having suitable skill, knowledge, and/or experience for purposes of the rule, underlying concepts supporting the requirement, how suitable skill, knowledge, and/or experience can be assessed, and which client personnel or other individuals can serve in this capacity. In addition, this document contains

a new FAQ as approved by the PEEC on May 19, 2005, related to "routine activities" as referenced in the Interpretation. This document can be found online at www.aicpa.org/download/ethics/101-3_Competency_Guidance.pdf.

- *AICPA Interpretation 101-3, Performance of Nonattest Services—Requirement to Document Understanding With an Attest Client* provides clarification and guidance regarding the requirement to document certain elements of a nonattest services engagement as required by Interpretation No. 101-3. Topics covered include affected clients and services, form of documentation, failing to document, and illustrative sample documentation language. In addition, this document contains a new FAQ as approved by the PEEC on May 19, 2005, related to "routine activities" as referenced in the interpretation. This document can be found online at www.aicpa.org/download/ethics/Int._101-3_documentation_guidance.pdf.
- *Bookkeeping and General Requirement Q&As (Revised January 27, 2005)* are based on responses of the AICPA professional ethics division staff to members' inquiries and recent changes to the independence guidance of the PEEC. The Q&As can be found online at www.aicpa.org/download/ethics/nonattest_q_a.pdf.

Recent Accounting Pronouncements and Related Guidance

.143 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. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
FASB Statement No. 156 (March 2006)	*Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*
FASB Statement No. 155 (February 2006)	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB EITF Issues (various dates)	Go to www.fasb.org/eitf/ for a complete list of EITF Issues.
FASB Staff Positions (various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FASB Staff Positions (FSPs). Some of the recently issued FSPs address issues relating to FASB Statements No. 13, No. 115, No. 123(R), No. 124, and No. 143, among others.
AICPA Statement of Position 06-1 (April 2006)	*Reporting Pursuant to the Global Investment Performance Standards*

(continued)

AICPA Technical Practice Aid section 1200.06–.15 (February 2005) (nonauthoritative)	"Accounting by Noninsurance Enterprises for Property and Casualty Insurance Arrangements That Limit Insurance Risk"
AICPA Technical Practice Aid section 2130.09–.35 (December 2005) (nonauthoritative)	"Application of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer,* to Debt Securities"
AICPA Technical Practice Aid section 5400.05 (September 2005) (nonauthoritative)	"Accounting and Disclosures Guidance for Losses From Natural Disasters—Nongovernmental Entities"
AICPA Technical Practice Aid section 5600.07–.17 (November 2005) (nonauthoritative)	"Determining a Lease Term for Accounting Purposes"
AICPA Technical Practice Aid section 6910.16–.20 (January 2006) (nonauthoritative)	"Presentation of Boxed Investment Positions in the Condensed Schedule of Investments of Nonregistered Investment Partnerships"
AICPA Technical Practice Aid section 6930.09 (August 2005) (nonauthoritative)	"Accounting and Disclosure Requirements for *Single-Employer Employee Benefit Plans* Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003"
AICPA Technical Practice Aid section 6930.10 (August 2005) (nonauthoritative)	"Accounting and Disclosure Requirements for *Multiemployer Employee Benefit Plans* Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003"
Statement on Standards for Accounting and Review Services (SSARS) No. 14 (July 2005)	*Compilation of Pro Forma Financial Information*. This SSARS expands SSARS to apply when an accountant is engaged to compile or issues a compilation report on pro forma financial information.
SSARS No. 13 (July 2005)	*Compilation of Specified Elements, Accounts, or Items of a Financial Statement*. This SSARS expands SSARS to apply when an accountant is engaged to compile or issues a compilation report on one or more specified elements, accounts, or items of a financial statement.

SSARS No. 12 (July 2005)	*Omnibus Statement on Standards for Accounting and Review Services—2005.* This SSARS amends SSARS No. 1, C*ompilation and Review of Financial Statements*, and SSARS No. 2, *Reporting on Comparative Financial Statements*. The SSARS also rescinds Interpretation No. 26, "Communicating Possible Fraud and Illegal Acts to Management and Others," of SSARS No. 1.
Interpretation No. 27 of AR section 100	"Applicability of Statements on Standards for Accounting and Review Services to Reviews of Nonissuers Who Are Owned by or Controlled by an Issuer"

On the Horizon

.144 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. You should check the appropriate standard-setting Web sites (listed below) for a complete picture of all accounting and auditing projects in progress. 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.

.145 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.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB) (Note that for audits of public companies, the PCAOB sets auditing standards.)	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.fasb.org
Governmental Accounting Standards Board (GASB)	www.gasb.org
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 have your e-mail address put on the notification list for all AICPA exposure drafts, send your e-mail address to service@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.

Auditing Pipeline—Nonpublic Companies

.146 The proposed standards discussed in this section would not apply to the audits of public companies and other audits conducted under the standards of the Public Company Accounting Oversight Board (PCAOB). Readers should keep abreast of the status of the following 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.

Proposed Statement on Standards for Attestation Engagements, Reporting on an Entity's Internal Control Over Financial Reporting

.147 This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). Specifically, guidance is provided regarding the following:

- Conditions that must be met for a practitioner to accept an engagement to examine the effectiveness of an entity's internal control and the prohibition of acceptance of an engagement to review such subject matter
- Engagements to examine the design and operating effectiveness of an entity's internal control
- Engagements to examine the design and operating effectiveness of a portion of an entity's internal control (for example, internal control over financial reporting of an entity's operating division or its accounts receivable)
- Engagements to examine only the suitability of design of an entity's internal control (no assertion is made about the operating effectiveness of internal control)
- Engagements to examine the design and operating effectiveness of an entity's internal control based on criteria established by a regulatory agency

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*

.148 The ASB has issued an exposure draft introducing a proposed SAS entitled *Amendment to Statement on Auditing Standards No. 69*, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards entitled *The Hierarchy of Generally Accepted Accounting Principles.* The FASB proposal would move responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69) to the accounting literature. The proposed SAS would delete the GAAP hierarchy for nongovernmental entities from SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards*, vol. 1, AU sec. 411), as amended. The ASB decided to coordinate the provisions and effective date of this exposure draft with the FASB proposed statement, which can be obtained at www.fasb.org.

Accounting Pipeline

Proposed FASB Statement, Qualifying Special-Purpose Entities and Isolation of Transferred Assets—an amendment of FASB Statement No. 140

.149 This proposed Statement would amend and clarify FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, in several ways. The objectives of this project are to amend FASB Statement No. 140 to (1) specify the conditions under which a qualifying special-purpose entity (SPE) is required to achieve sale accounting, (2) eliminate inconsistent application of the principles FASB Statement No. 140 is based on, and (3) address other issues related to transfers of financial assets that arose during redeliberations on the amendment of FASB Statement No. 140 in order to improve the comparability of financial statements.

.150 Readers should be alert for the issuance of a final statement, which is expected to occur in the second quarter of 2007. Refer to the FASB Web site at www.fasb.org for complete information.

Proposed FASB Statement, The Hierarchy of Generally Accepted Accounting Principles

.151 This proposed Statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, who is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA and the PCAOB in order to ensure that each of the documents has a uniform effective date.

Proposed FASB Statements, Business Combinations, *and* Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries

.152 The primary objective of applying the acquisition method project is to develop a single high-quality standard of accounting for business combinations that can be used for both domestic and cross-border financial reporting. The goal is to develop a standard that includes a common set of principles and related guidance that produces decision-useful information and minimizes exceptions to those principles. The standard should improve the completeness, relevance, and comparability of financial information about business combinations by:

1. Clarifying which assets and liabilities should be recognized in the initial accounting for the business combination.
2. Requiring that the assets acquired and the liabilities assumed be consistently measured at a relevant attribute.
3. Defining the scope of the standard in a way that ensures that similar economic events are accounted for similarly. (That means, by requiring that all transactions or other events in which an acquirer obtains control of a business be accounted for by applying the acquisition method).

.153 The exposure drafts on business combinations, purchase method procedures, and noncontrolling interests were published on June 30, 2005. The FASB's goal is to issue the two final Statements in the first half of 2007. The target effective date for the two proposed Statements will be reviewed near the end of redeliberations.

AICPA Audit and Accounting Products and Services

AICPA

Web Site

.154 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 (Service Center Operations)

.155 To order AICPA products, call the AICPA Member 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

.156 The following publications deliver valuable guidance and practical assistance as potent tools to be used on your engagements (product numbers appear in parentheses).

- *Checklists and Illustrative Financial Statements for Common Interest Realty Associations* (product no. 008907kk). This publication is designed to help those preparing reports and financial statements of CIRAs by providing a checklist of applicable GAAP disclosures.
- Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide (product no. 006615kk)
- *Analytical Procedures* Audit Guide (product no. 012551kk)
- *Auditing Estimates and Other Soft Accounting Information* Practice Aid
- *Accounting Trends and Techniques—2006* (product no. 009898kk)
- *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* Practice Aid (product no. 006701kk)
- *Understanding and Implementing SSARS No. 8* (product no. 006612kk)
- *Audit and Accounting Manual* (product no. 005133kk). This 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 and engagement letters, management representation letters, and confirmation letters.

Accounting and Auditing Technical Hotline

.157 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.158 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.

Online CPE

.159 AICPA *CPExpress*, offered exclusively through CPA2Biz.com, is the AICPA's flagship online learning product with enhancements such as a new user interface and improved functionality. AICPA *CPExpress* now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 (nonmembers pay $369) for a new subscription and $119 (nonmembers pay $319) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA *CPExpress* offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com.

Technical Practice Aids

.160 *AICPA Technical Practice Aids* includes questions received by the AICPA Technical Hotline on various subjects and the responses to those questions. TPA section 6990 includes a question and answer specifically pertaining to CIRAs. *Technical Practice Aids* is available both as a subscription service and in paperback form (product no. 005146kk).

Help Desk—AICPA publications can be obtained by calling AICPA Member Service Center at (888) 777-7077 or faxing a request to (800) 362-5066.

Guidance for Audit Committees on the Risk of Fraud From Management Override of Internal Control

.161 The AICPA Antifraud Programs and Controls Task Force has issued a document entitled *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention—The Audit Committee and Oversight of Financial Reporting*. The document offers assistance to audit committees in addressing the risk of fraud arising from management override of internal control over financial reporting. The guidance contains the following major sections:

- Management Override and the Audit Committee's Responsibilities
- Actions to Address the Risk of Management Override of Internal Controls
- Suggested Audit Committee Procedures: Strengthening Knowledge of the Business and Related Financial Statement Risks (Appendix)

.162 The following are some of the topics related to audit committees that are covered in the document:

- Maintaining an appropriate level of skepticism.
- Strengthening the audit committee's understanding of the business.
- Brainstorming to identify fraud risks.
- Using the code of conduct to assess financial reporting culture.
- Cultivating a vigorous whistle-blower program.
- Developing a broad information and feedback network including communications with internal auditors, independent auditors, compensation committee, and key employees.

.163 The document can be downloaded from the "Spotlight Area" on the AICPA's Audit Committee Effectiveness Center Web page at www.aicpa.org/audcommctr/homepage.htm.

References for Additional Guidance

.164 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—2006/07* (product no. 022337kk) and the AICPA *Compilation and Review Alert—2006/07* (product no. 022307kk). These Alerts may be obtained by calling AICPA Member Service Center 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.

.165 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.

.166 The Audit Risk Alert *Common Interest Realty Associations Industry Developments* is published as warranted. 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:

Lori A. West, CPA
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

Appendix

Useful Internet Web Sites

.167 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 common interest realty associations (CIRAs) and their finance professionals, professional news, state CPA society information, Internal Revenue Service (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, often free of charge.

.168 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

.169 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.

.170 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 CIRAs may find useful.

Association-Related Information

Organization	*General Contact Information*	*Internet Address*
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, Suite 500 Washington, DC 20005 (202) 371-6700	www.arda.org

General Web Sites of Interest

Name of Site	*Content*	*Internet Address*
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/
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.gov
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/
FannieMae	FannieMae-sponsored site providing access to products and other FannieMae information	www.fanniemae.com
FreddieMac	FreddieMac-sponsored site providing access to products, forms, business tools, and other FreddieMac information	www.freddiemac.com

(continued)

Name of Site	*Content*	*Internet Address*
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/

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AAM Section 8090

Construction Contractors Industry Developments—2007/08

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS

CONSTRUCTION CONTRACTORS INDUSTRY DEVELOPMENTS—2007/08

This Audit Risk Alert is intended to provide auditors of financial statements of construction contractors with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

Christopher Cole, CPA CFE
Technical Manager
Accounting and Auditing Publications

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your construction contractor audits. This alert can also be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory 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 financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The construction industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic, and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the entity's financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, GDP increased at an annual rate of 2.9 percent in 2006, consistent with the pace of growth experienced in 2005 when GDP increased by 3.1 percent. During the first quarter of 2007, GDP increased by an annual rate of only 0.6 percent. However, according to second quarter preliminary estimates, GDP increased at an annual rate of 4.0 percent.

.11 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, with an annual average rate of 4.6 percent representing approximately 7 million people. The 2006 rates represent the lowest annual rate and total number of jobless since 2000, according to the U.S. Department of Labor, Bureau of Labor Statistics. During the first half of 2007, the unemployment rate averaged 4.5 percent. These data further demonstrate the economic growth the United States has experienced since the beginning of 2006.

.12 After a period of rising rates during the first half of 2006, the Federal Reserve kept its target for the federal funds rate at 5.25 percent for 10 consecutive meetings (June 2006–August 2007). At that time, the Federal Reserve indicated future federal fund rate adjustments would likely depend upon the outlook for economic growth and inflation. Since its August 2007 meeting and in response to shaky financial market conditions, the Federal Reserve has taken several action steps. It announced that it would provide reserves as necessary through the open market to facilitate the orderly functioning of financial markets by promoting trading in the federal funds market at rates close to the 5.25 percent target rate. On August 17, 2007, it announced that financial market conditions had deteriorated and tighter credit conditions and increased uncertainty have the potential to restrain economic growth. Then at its September meeting, the Federal Reserve decided to lower its target for the federal funds rate 50 basis points to 4.75 percent citing increased uncertainty surrounding the economic outlook. The Federal Reserve also decided to decrease the discount rate 50 basis points to 5.25 percent to consistently keep the spread between the primary credit rate and the target federal funds rate at 50 basis points. Auditors should remain alert to developments in the financial markets and how they may affect your audit engagements.

Industry Trends and Conditions

.13 Despite continued weakness in the residential sector, there have been solid gains in most nonresidential construction sectors so far, and robust conditions are expected to continue for the remainder of the year. The American Institute of Architects (AIA) Consensus Construction Forecast Panel projects growth of 7.2 percent in nonresidential construction activity (after inflation adjustments) for 2007, with an almost 9 percent jump in commercial activity, and a healthy 5.4 percent increase in institutional facilities. They are projecting to see much slower gains in 2008, but gains nonetheless. Commercial construction is expected to edge up another 1.1 percent, with institutional activity growing by 4.5 percent, producing an almost 3 percent gain in total activity for 2008.

.14 However, there is a growing list of concerns in the economic outlook. The housing market continues to deteriorate and is not only slowing the economy directly, but may cause consumers to decrease spending as a result of their anxiety about falling home prices. Also, there is growing concern that inflation may begin to accelerate in our economy. High oil prices continue to add pressure to inflation, and long-term interest rates have begun to trend up recently. Inflation in building commodity prices has been a major source of disruption to the construction industry in recent years, but fluctuations in commodity prices have fortunately begun to moderate recently.

.15 Though most members of the AIA Consensus Construction Panel were expecting a good year for nonresidential construction in 2007, so far this year activity has largely exceeded even the most optimistic outlooks. Although total construction spending slipped 0.4 percent in July (seasonally adjusted) and residential fell 1.4 percent, nonresidential spending climbed 0.6 percent (the tenth consecutive monthly gain). For the first seven months of 2007 combined, total construction was down 3.4 percent, and residential plummeted 18 percent compared to the same period in 2006. Those figures obscure the 15 percent jump in nonresidential spending.

Construction Put in Place

.16 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 the following:

- 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 work
- Any miscellaneous costs of the project that are on the owner's books

.17 The total value of construction put 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.

.18 The following table 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.

New Construction Put in Place
(Billions of Dollars—Seasonally Adjusted Annual Rate, in Current Dollars)

	July 2007	*July 2006*
Private construction	$ 880.1	$ 930.9
Public construction	289.0	269.1
Total construction	**$1,169.1**	**$1,200.0**
Nonresidential building		
Office	$ 53.9	$ 45.1
Power	37.7	34.7
Commercial	82.4	77.2
Lodging	29.3	21.0
Other nonresidential	142.7	125.5
Total nonresidential	346.0	303.5
Residential building	534.1	627.4
Total private construction	$ 880.1	$ 930.9

	July 2007	July 2006
Highways and streets	$ 74.3	$ 76.6
Infrastructure	39.7	36.9
Educational	83.0	69.9
Other public buildings	33.8	24.6
Other public construction	58.2	61.1
Total public construction	$ 289.0	$ 269.1

.19 The U.S. Census Bureau of the Department of Commerce announced that construction spending during July 2007 was estimated at a seasonally adjusted annual rate of $1,169.1 billion (0.4 percent below the revised June 2007 estimate of $1,173.2 billion). The July figure is 2.0 percent below the July 2006 estimate of $1,192.9 billion. During the first seven months of this year, construction spending amounted to $657.7 billion (3.4 percent below the $680.9 billion for the same period in 2006).

.20 Spending on private construction was at a seasonally adjusted annual rate of $880.1 billion (0.7 percent below the revised June 2007 estimate of $886.3 billion). Residential construction was at a seasonally adjusted annual rate of $534.0 billion in July (1.4 percent below the revised June estimate of $541.8 billion). Nonresidential construction was at a seasonally adjusted annual rate of $346.0 billion in July (0.4 percent above the revised June estimate of $344.5 billion).

.21 In July 2007, the estimated seasonally adjusted annual rate of public construction spending was $289.0 billion (0.7 percent above the revised June estimate of $287.0 billion). Educational construction was at a seasonally adjusted annual rate of $83.0 billion (1.9 percent above the revised June estimate of $81.5 billion). Highway construction was at a seasonally adjusted annual rate of $74.3 billion (0.8 percent below the revised June estimate of $74.9 billion).

> **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

.22 The residential building segment of the construction industry includes new single- and multifamily housing as well as residential repairs and improvements. Conditions that have the most effect 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, and interest rates therefore 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 must be in effect for several quarters to reverse home-buying trends.

- *Land availability and pricing.* Because land is one of the major costs of residential building, land availability and pricing have a major effect on the affordability of housing. Housing prices will be affected as land suitable for residential building becomes scarce in certain parts of the country.

- *Demographics*. Shifts in demographics can have a significant effect 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.

.23 Housing starts have stabilized so far in 2007 at just below 1.5 million units, but job-site spending has declined about 1 percent per month, reflecting slower completion of homes and cutbacks in home size and amenities in a depressed sales market. Some industry analysts believe housing starts are near the bottom for this cycle, although one or two lower monthly starts reports are possible. Further, some believe recovery will be slow, held back by an oppressive overhang of inventory of homes for sale, which are mostly existing homes.

.24 All of the other usual drivers in the housing market are neutral to slightly positive and are expected to improve through 2008. A leading business information firm, Reed Construction Data, forecasts that about 40 percent of the 2006–2007 drop in housing starts will be recovered by the end of next year. This would still leave starts well below the underlying demographic trend demand (that is, population and household growth and shifts). Such an anticipated recovery requires the forecasted return to 3.0 percent real GDP growth, so that the inventory surplus is absorbed almost as quickly as it appeared. However, other housing forecasts are generally less optimistic.

Nonresidential Building

.25 The boom in nonresidential building construction continues but is showing signs of peaking. Construction spending is now 15 percent higher for the first 7 months of 2007 than for the same period in 2006, and the value of starts is up 22 percent. Over that period, starts are up 29 percent for commercial buildings, 10 percent for institutional buildings, and have doubled for manufacturing facilities.

.26 For-lease buildings remain the construction market with the fastest growth. Year-to-date starts are up 55 percent for hotels, 46 percent for offices, 27 percent for stores, and 25 percent for warehouses. Job-site construction spending for these buildings is up 24 percent year-to-date, and analysts expect continued growth at about this pace or perhaps a little faster. These investment buildings continue to be attractive to the financial market, although analysts expect their relative attractiveness to ebb over the next year as completions rise and restrain increases in rents and occupancy rates.

Public Construction

.27 Public construction was up 0.7 percent in July 2007 and 11 percent year-to-date. The biggest component, education, rose 1.9 percent in July 2007 and 12 percent year-to-date. However, highway and street construction, which received a big boost in late 2005 and early 2006, was down 0.8 percent for the month of July 2007 and was only 5 percent higher year-to-date. That partly reflects lower prices for diesel and asphalt, but it also shows that states are running short of highway funds as gas tax receipts slow. Accordingly, highway spending could drop sharply in late 2008. In August 2007, the Congressional Budget Office projected a $5 billion deficit in the federal Highway Trust Fund's Highway Account in fiscal year 2009. Congress will need to bridge that gap to keep road spending from plunging.

.28 The growth pace for institutional contracts has slowed due to the sharp decline in tax-receipt growth over the last several quarters and the accompanying drop in public budget reserves. The tax situation is now reversing in a stronger economy, so no further drop in the growth of institutional starts is expected. Healthcare is the strongest area of the institutional sector because it is less dependent on tax receipts.

Surety Industry Trends

.29 The surety industry is critical to the well-being of the construction industry. Nearly half of all work performed by construction contractors is bonded, so any change in the surety market will have a significant effect on the construction industry. The surety bond market is continuing to make a slow recovery. As the economy improves, bonding companies are loosening up on the self-preservation safeguards imposed when the reinsurance market plummeted.

.30 Reinsurance allows a bonding company to spread its risk among special reinsurance markets, lessening the effect of claims on any one company. That market still has not fully recovered, leaving fewer reinsurance companies available for bonding companies to spread risks. As a result, sureties offering performance and payment bonds are more selective in allocating their capacity and have less tolerance for underperforming or risky clients.

.31 Bonding companies are more judicious in that they are choosing clients with stronger financial margins and high quality accounting presentations in both internal and external reporting. Coming out of a "hard" market, sureties are still cautious, which means contractors often feel the consequences.

.32 Construction contractors that work for private sector owners may often secure a job on a handshake, but contractors doing hard-bid work for public agencies are required by law to be bonded. Larger contractors may have trouble bonding projects over $100 million due to the reinsurance market. Contractors sometimes find that the bonding capacity just is not available for larger sized projects. In these cases, it may take the involvement of several surety companies to secure the required bonding.

.33 In an attempt to avoid high bond premiums and potentially time-consuming and expensive investigations, some contractors are turning to an alternative form of protection against subcontractor default. Contractor default insurance (CDI) is a policy that replaces traditional subcontractor bonds. A construction contractor purchases the policy, which obligates the insurer to reimburse the contractor for costs related to subcontractor default. The subcontractors are added to the contractor's policy instead of requiring them to post bonds.

.34 The advantages of an insurance policy over traditional bonds are lower premium costs and a greater flexibility in addressing and resolving subcontractor defaults. Because a surety is entitled to conduct a routine and often time-consuming investigation in the case of a default, a CDI may bring a more timely response to the problem. A contractor can remedy a situation by using its own forces or by hiring a new subcontractor as soon as a subcontractor defaults and then immediately submitting the costs for later reimbursement.

.35 On the other hand, there is no contractual obligation under a CDI policy for an insurer to step in and complete a subcontractor's work, unlike a bonding company. The CDI underwriter also has no payment obligation to a subcontractor or its suppliers the way a bonding firm would. The construction manager assumes these risks and is held to the terms and conditions of the insurance policy. When a loss is reimbursed, the payout is subject to typically large deductibles, copayments by the insured, and strict project-specific and overall loss limits.

Construction Cost Trends

.36 From early 2004 to mid-2006, the construction industry was plagued by runaway materials cost increases. Many of these price increases have slowed or even reversed course modestly in recent months. Unfortunately, it seems likely that the current calm is only a lull between storms and not a return to the inflation-free period of 2001–2003. However, economists at the Associated General Contractors of America (AGC) and McGraw-Hill Construction say contractors can expect a better year for most materials, despite uncertainties about fuel prices. However, unknowns include how much pressure on materials and prices will be eased by the housing slowdown, how the tighter immigration policies in some states will affect the labor market, and what will happen in Congress.

Asphalt

.37 According to AGC, the biggest concern in materials for 2007 and beyond is probably asphalt. Asphalt was in short supply in 2006, and prices spiked as high as 30 percent in some areas. Colorado, Hawaii, and Wyoming experienced some of the worst shortages. This same scenario could play out again because many refineries are planning to install new cokers and eliminate the residual that has been sold as asphalt. Construction contractors need to work closely with their asphalt suppliers regarding upcoming changes in the source and availability of the supply and be prepared to look further afield. This will be an evolving situation even beyond 2007. Other refineries might decide to supply markets they had not been serving before as they adjust their product lines to maximize profit levels.

Copper

.38 Economists at both AGC and McGraw-Hill expect copper prices to remain elevated. Construction contractors buying pipe or wire can expect only slight fluctuations in prices. Contractors must also be mindful of widespread thefts and vandalism of copper products from storage and building sites. There is some potential for a price decrease as a result of the lower demand in the housing market. Overall, copper prices will continue to be high in 2007.

Steel

.39 Steel should be widely available this year; however, concern over the demand from China continues to exist. There have been some impressive increases in China's own industrial capacity, and contractors should monitor this situation to gauge the effect on the steel market in 2007 and beyond.

Cement

.40 Cement supply has been a troublesome area in the past but will probably be less so in the future. There has been an expansion of the domestic supply, which should continue, as well as continued increase in supply from Mexico. Price increases should be moderate, perhaps somewhere around 3 percent to 5 percent.

Gypsum

.41 According to economists at AGC and McGraw-Hill, the sharp decline in housing and remodeling construction will make for significantly lower demand for gypsum. Gypsum prices were up approximately 20 percent in 2006 but only 3 percent to 4 percent in 2007. The further good news is that prices for gypsum should actually decrease in the future, maybe even as much as 10 percent to 20 percent, as demand drops.

Fuel

.42 According to McGraw-Hill, the price pressures will not be as extreme in the future as in the current environment. The likelihood of any sharp decline in prices is remote. A slowing U.S. economy and less demand could affect prices this year, but the fuel market is a difficult market to predict. There is significant volatility and a multitude of factors that affect fuel supply and consequently pricing, including strikes, weather, wars, and political instability.

Construction Plastics

.43 The supply of PVC pipe was very tight after the hurricanes in late 2005, and prices increased 5 percent in 2006. However, prices should be flat or even slightly lower for construction plastics in 2007 and beyond, according to AGC. In addition, there is ample supply, primarily because the decrease in home building is reducing demand pressures on existing suppliers.

Legislative and Regulatory Developments

Three Percent Withholding Tax

.44 In 2012, a new law will require federal, state, and local governments to withhold 3 percent from all payments for goods and services as a guard against possible business tax evasion. This far-reaching new requirement was inserted as a last-minute revenue raiser into the Tax Reconciliation Act of 2005 that was signed by the President in May 2006. The law does the following:

- Requires withholding of 3 percent on all government payments for products and services made by the federal, state, and local governments with total expenditures of $100 million or more
- Affects payments for goods and services under government contracts as well as payments to any person for a service or product provided to a government entity (for example, Medicare and certain grants)

.45 According to a 2006 Construction Financial Management Association Survey, construction companies make, on average, 2.2 percent per contract. If this law is implemented, the government may withhold more than the profit from every contract, in theory to pay for business taxes. This over-withholding may result in severe cash flow deficiencies, increased costs for bonding and lowered bonding capacity, and possibly bankruptcies.

.46 For example, if a small business contractor holds one government contract estimated to be completed in one year for $10 million, this law requires withholding of $300,000 on that contract. Meanwhile, the contractor expects to net approximately 2.5 percent, or $250,000, after paying for supplies, services, subcontractors, and other ordinary business expenses. The tax on the revenue generated is at most 35 percent of the revenue, which means the maximum tax owed on the $10 million project is $87,500 (35 percent of $250,000). Ultimately, the government has withheld $300,000 for $87,500 in tax liability.

.47 A number of construction-related organizations are working to have this section of the Tax Reconciliation Act of 2005 repealed.

Audit and Attestation Issues and Developments

Auditing Construction Contracts

.48 As we mentioned in the first part of this alert, in the construction industry, business conditions vary greatly across construction sectors and from region to region. Risks associated with erecting schools are different from those faced by a homebuilder. Likewise, a contractor in the Northwest may face different issues than a similar contractor on the Gulf Coast. For this reason, auditors must be knowledgeable about the types of construction contracts that contractors use and the regions in which the entity operates.

.49 The financial statements of a contractor are built from the financial results of individual contracts. Therefore, an effective audit approach focuses on the terms, financial estimates, and results of individual contracts rather than on the contract-related balance sheet that accounts for the entity as a whole.

.50 To obtain a general understanding of the nature of a construction contractor's operations, you should review the terms of a representative sample of the contractor's contracts, including significant contracts that are currently in force. This sample should include both contracts with customers and contracts with subcontractors. Information that you would expect to find in the contracts includes the following:

- Job number
- Type of contract
- Contract price
- Original cost estimate and related gross profit
- Billing and retention terms
- Provisions for changes in contract prices and terms, such as escalation, cancellation, and renegotiation
- Penalty or bonus features relating to completion dates and other performance criteria
- Bonding and insurance requirements
- Location and description of project

.51 The authoritative guidance on auditing contractors is contained in the AICPA Audit and Accounting Guide *Construction Contractors* (product no. 012587kk). 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*, (AICPA, *Technical Practice Aids*, ACC sec. 10,330), which is the primary authoritative accounting guidance for construction contractors.

Fixed-Price Contracts

.52 A fixed-price contract is generally considered the riskiest for both the contractor and the auditor. As the riskiest contract type in an audit, you must employ all of your available audit tools to verify the total contract amount, the collectibility and likelihood of contract changes, and the status of the contract as of the balance sheet date. Auditing procedures related to revenue for this type of contract may consist of the following:

- Confirming contract terms and status
- Testing the contractor's business functions over estimating, billing, collection, project management, and generally all controls that influence the contractor's ability to manage estimates
- Testing the contractor's subsequent performance
- Measuring the contract job gain or fade trends by comparing the contractor's ability to estimate by using original estimated contract revenues and costs and comparing these figures to period end amounts and final contract amounts for a period of several years
- Using other analytical procedures

Cost-Type Contracts

.53 Cost-type contracts present a lower level of risk. With this type of contract, the audit procedures should be focused on the contract provisions concerning the definition of contract costs and the associated revenue entitlements of the contractor. If the contract clearly defines allowable costs, overhead calculations and allocations, agreed-upon profit, and payment terms, the auditor's job is easier and can then be focused on the realization of collection and the creditworthiness of the owner. There are many variations of the cost-type contracts that present various degrees of concern and additional audit requirements for the auditor.

Time and Material Contracts

.54 Time and material contracts also present lower risk revenue issues for the auditor as long as the contractor has identified all of its costs, including its overhead costs, and has defined its required gross profit.

The audit focus in this type of contract comes back to the contractor's internal controls and the ability to fully identify and capture its costs—direct, indirect, and overhead. Auditing procedures that can be employed could include internal controls testing and subsequent billings and collections of the outstanding time and material costs as of the period end.

Unit-Price Contracts

.55 Unit-price contracts are often variations of fixed-price contracts. Under a unit-price contract, the contractor knows the amounts that will be due as each unit is performed. Audit procedures in this area may consist of the following:

- Verifying the work performed with outside parties through the use of confirmations, including the terms of the contract
- Verifying the terms of the contract concerning the provisions for unit prices, their amounts, and contract billing terms by examining the contract
- Determining the revenue balance available to be performed and billed under the contract

.56 Other procedures to be applied may be similar to the procedures applied to fixed-price contracts.

Service Contracts

.57 Service contracts can include a blend of other contract types, such as time and material. You should separate these other contract type elements and perform the appropriate testing under those categories. A service contract can consist of labor only or labor and material. The terms of the contract should be reviewed for the risks that the contract presents to the contractor and the audit. For example, does the contract cover maintenance only with breakdowns covered at fixed time and material rates and costs? The risk of loss on such a contract would be minimal. On the other hand, does the service contract provide for the provision of a guaranteed service, such as uninterrupted power (which may be necessary for the function of a hospital)? This type of contract would require more extensive auditing procedures that would involve auditing the contractor's ability to produce reliable estimates similar to a fixed-price contract. If a service contract has only provisions for maintenance and the minimal supply of parts, the revenue auditing procedures may consist of the following:

- Scheduling the earned and unearned parts of the contract and recording the unearned part as deferred revenue.
- Examining the contractor's system that tracks the performance of the required or contractual provision of periodic services, if any, to see that they have been performed. This could result in a liability that would need to be measured.
- Determining whether the contractor has the ability to cost each service contract to determine whether the service contract requires a loss reserve.
- Testing the service revenues and costs analytically to see if the gross profit earned is typical compared to industry averages.
- Testing the contractor's prior ability to estimate with reasonable certainty. Service contracts that have provisions that require estimates should be tested in a manner similar to a fixed-price contract.

Construction Management Contracts

.58 Construction management contracts can also be a blend of the various types of contracts described and defined in the previous sections. The particular attributes or details of the contract should be examined to see if these other attributes exist. For example, the contract may call for the contractor to act as agent under a fee arrangement but permit it to perform certain parts of the construction if it deems that it can perform the work for five percent less than the lowest bidder. The construction part will need to be tested and audited as a construction contractor. The audit risk that a construction management contract presents will depend on the contract terms. If a construction management contract calls for a fee based upon a percentage of costs, audit risk is lower. On the other hand, if the construction management contract fee is a fixed price, you will need to examine the revenue recognition methods and test the progress to date. For example, if a contractor estimates that it will take 1,000 man-hours to earn the construction management fee of $500,000 over an 18-month period, you can examine the hours performed to date and the estimate of the hours to complete. In addition, the calculation of hours to date to total estimated hours can be compared to the physical estimate of percentage of completion for reasonableness. Testing of the contractor's internal controls and prior ability to estimate with reasonable certainty can also be used to gather audit evidence.

Design-Build

.59 The design-build contract is a new type of contract and is continuing to be an increasingly popular vehicle for contract performance. The audit risk involved in this type of contract focuses on the detail of the contract terms. Is the contractor going to be reimbursed for its costs under a cost-type arrangement? Is the contract broken out into various pieces where the contractor bids separately on the design and construction work in different phases? The answers to these questions and other facts and circumstances may lead you to make judgment calls about the appropriateness of the use of audit procedures described under the contract types listed in the previous sections. If a design-build contract outcome is uncertain, you should consider whether the contract should be accounted for under alternative revenue recognition methods such as zero profit or the completed-contract method until measurements are reliable and more certain.

Contracts With Incentive Provisions

.60 All the contract types described in the previous sections may have provisions for incentives. The audit of a contract that includes incentive provisions may consist of the following procedures:

- An examination of the contract terms to determine the conditions for incentive achievement
- A test to see if the conditions for achievement have been met
- Confirmation of incentive earnings
- Subsequent billing and collection of incentive revenues
- Analysis of whether incentive provisions can be earned incrementally or are under "all or none" terms
- A determination of whether the incentive should be considered a gain contingency properly accounted for under Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*

Using Hedging Transactions to Manage Risk

.61 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). FASB Emerging Issues Task Force (EITF) Issue No. 99-2, "Accounting for Weather Derivatives," prescribes the accounting treatment for weather derivatives.

.62 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, provides the primary guidance on accounting for hedging transactions. In addition, you should be familiar with AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), and the AICPA's Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012527kk), which provides practical guidance to accompany AU section 332. 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.

.63 If your client holds derivative instruments or engages in hedging transactions, you should become thoroughly familiar with the authoritative accounting and auditing literature relating to derivatives.

Debt Covenants

.64 Loan terms, including covenants, are worthy of special attention for audits of construction contractors. Violation of a loan covenant can have a material effect on the financial statements and on the organization's ability to continue operations. You should carefully review loan agreements and test for compliance with loan covenants. In this regard, consider any "cross default" provisions, which are violations of one loan covenant that affect 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.

.65 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 may not generate as much cash flow as it did in previous years due to current economic and industry conditions.

Auditing Estimates

.66 Remember that the audit of a construction contractor's financial statements is essentially an audit of the contractor's ability to estimate. Therefore, it is critical that you gain an understanding of the contractor's significant estimates and assumptions that are used in operating the business. AU section 342, *Auditing Accounting Estimates* (AICPA *Professional Standards*, vol. 1), provides a list of procedures that serve as a good basis for auditing the estimates found in a construction contractor's financial statements.

.67 In many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. The following are procedures the auditor may consider performing when using this approach:

a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.

b. 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.

c. Consider whether there are additional key factors or alternative assumptions about the factors.

d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.

e. 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.

f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.

g. Review 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.

h. Consider using the work of a specialist regarding certain assumptions (AU section 336, *Using the Work of a Specialist* [AICPA, *Professional Standards*, vol. 1]).

i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.

.68 Based on the auditor's understanding of the facts and circumstances, he may independently develop an expectation as to the estimate by using other key factors or alternative assumptions about those factors.

.69 Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the date of the auditor's report, that are important in identifying and evaluating the reasonableness of accounting estimates or key factors or assumptions used in the preparation of the estimate. In such circumstances, an evaluation of the estimate or of a key factor or assumption may be minimized or unnecessary as the event or transaction can be used by the auditor in evaluating their reasonableness.

Using the Work of a Specialist

.70 It may be necessary to use a specialist (such as construction engineer) to perform or assist in job site visits or other audit procedures. The specialist may help you gain assurance as to the percent complete, identify problems on the job, and identify possible uninstalled materials or inventoriable items. In addition, the specialist will generally be able to communicate effectively with job site personnel.

.71 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 paragraph .06 of AU section 336, 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 appropriate audit evidence.

.72 Involvement of a specialist should be considered during audit planning because of the lead time necessary to contract for a specialist's services and the time required for you to obtain the minimum knowledge necessary to supervise the specialist. According to paragraph .10 of AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1),

> 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 planned audit procedures. The auditor's responsibilities with respect to using such a professional are equivalent to those for other assistants.

.73 The use of a specialist is an excellent way to learn the construction contractor's business and can be helpful from initial planning through site visits and fieldwork.

Going Concern

.74 Business failure among construction contractors is common for many reasons. The construction industry is complex and requires a great deal of planning and organization, especially when dealing with long-term contracts and labor and materials issues that are dictated by forces external to the entity. The volatility of the housing market has compounded that problem over the past year and will continue to be an issue in the coming years. Some examples of indicators that there could be substantial doubt about the ability of the entity to continue as a going concern include the following:

- Negative trends such as recurring operating losses, working capital deficiencies, or negative cash flows from operating activities
- Other indications of possible financial difficulties such as loan covenant violations or denial of usual trade credit from suppliers and denial of surety credit
- Internal matters such as labor difficulties; turnover in key positions such as CFO, controller, or project managers; or substantial dependence on the success of a particular project
- Lack of significant backlog to cover overhead
- External matters such as legal proceedings or an uninsured catastrophe

.75 In addition to these matters, the current uncertain economic situation may cause you to have a heightened sense of awareness of a company's ability to continue as a going concern. AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), addresses the auditor's responsibilities to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern.

.76 Consider testing to see if the gross profit in the backlog will be sufficient to carry the company through the remainder of the next fiscal year. You should be careful in this evaluation if the client's history indicates significant gross profit fade. If this is the case, the analysis should be discounted when making an overall evaluation of the entity's ability to continue as a going concern.

.77 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 from only one or a few carriers. Such situations will affect the contractor that has a long-term contract bid initiated when insurance rates were lower and could call into question the going-concern assumption for a contractor that cannot obtain insurance.

.78 Also be aware of other issues that may affect the entity's ability to continue as a going concern, such as the following:

- *Inadequate capitalization.* Although many construction contractors have an understanding of the amount of capital that is required to start their businesses, some fail to take into account the funds that will be required to sustain the new companies until cash begins to flow in. Adequate working capital, typically 5 percent to 10 percent, and the ability to obtain additional bank financing when needed are signs that a contractor has sufficient resources to support operations. Additionally, the use of short-term financing affects working capital calculations. Using this type of financing to purchase assets with long cost recovery periods, such as construction equipment, might absorb cash needed for current operations and can result in reduced surety bonding capacity.
- *High employee turnover.* A construction company cannot succeed without experienced estimators, project managers, and superintendents. Familiarity with the company's strengths and resources improves the accuracy of bids and improves the likelihood of completing projects within budget

and profit projections. Turnover in these positions can result in underbidding of jobs and lower job profitability through inefficient use of resources.

- *New types of projects.* In the same way that you would not expect a cardiologist to perform brain surgery, each construction specialty area requires a skill set that is specific to that type of project. When contractors venture into new areas (for example, a highway contractor decides to build an office building), new business risks and issues arise that may affect performance and profitability.
- *Increase in job size.* New risks and challenges arise when contractors bid on jobs that are substantially larger than their normal jobs. A $5 million project is much more complex than a $500,000 job in terms of the resources, knowledge, and project management skills required.
- *New geographic areas.* A contractor in South Carolina faces different issues than a contractor in Montana. It is more difficult to manage a contract in a region of the country that you are not familiar with. In addition, there may be issues with finding an adequate labor supply; assessing the quality of subcontractors available in that area; establishing relationships with new suppliers; learning and complying with local codes and regulations, lien laws, and tax laws; and becoming familiar with differences in weather and site conditions.
- *Rapid growth.* Taking on too many projects at one time can stretch a contractor's resources past the point of job quality and profitability. If a contractor does not have access to the appropriate number of experienced project managers, existing managers may be spread too thin or additional managers may be hired who do not have the necessary experience. Additionally, if controls or administrative staffing levels are inadequate, billings may not be accurate or timely, which could negatively affect cash flows and result in subcontractors, suppliers, and employees not being paid in a timely manner or even result in loss of job profit.

.79 In summary, when evaluating management's plans to continue as a going concern, an appropriate level of professional skepticism is important. The company's assumptions about its ability to continue as a going concern should be scrutinized to assess whether they are based on overly optimistic or "once in a lifetime" occurrences.

Cost Shifting

.80 Cost shifting is an accidental or deliberate misstatement in a contractor's job cost system that can have a substantial effect on the contractor's balance sheet and income statement. The most dangerous type of cost shifting involves moving or misdirecting job costs from an unprofitable job to a profitable job. Cost shifting occurs most frequently when field-level managers attempt to manipulate contract profitability.

.81 The effect on the balance sheet from cost shifting is that underbillings (costs and estimated billings in excess of billings) increase and overbillings (billings in excess of costs and estimated earnings) decrease. However, if a loss contract is involved, the accrued liability for loss will be affected, which in turn will affect deferred taxes if an entity is a C-corporation. Underbillings should be rare, especially on contracts that are over 50 percent complete. You should look at underbillings skeptically and investigate each underbilling carefully.

.82 Certain standard audit procedures may not detect cost shifting. Tests designed to search for unrecorded liabilities or to detect improper cutoff will only provide assurance that all costs have been reported in the proper period. Tests designed to locate improperly booked billings or receivables will detect no exceptions. Audit test work for cost shifting must focus on the accuracy of job costing procedures as well as on the cost classification and coding process.

.83 Intentional cost shifting constitutes fraud. An audit is designed to provide reasonable assurance that the statements are free of material misstatement caused by fraud; therefore, consider the following steps in this regard:

- *Test job costs for accuracy.* An audit of a construction contractor should include tests of contract costs and related cost coding.
- *Compare job costs to bid documents.* Because contractors should estimate contract costs in the same manner in which they record job costs, you should test job costs for significant contracts by comparing each item of job cost to the original cost estimate. In addition, field personnel can shift costs by directing a subcontractor to invoice the wrong contract. Audit tests that compare subcontract costs to original bid documents are designed to detect this type of cost shifting.
- *Test revised profitability estimates to bid documents.* Often, cost shifting is accompanied by an upward revision in contract profitability. Consider testing revised profitability estimates in the same manner in which job costs are compared to bid documents.
- *Perform analytics on job cost components.* Contractors who perform similar types of work should have comparable costs from job to job. For example, a grading contractor with equipment-related costs equal to 40 percent of overall direct costs should have a similar relationship on other jobs.
- *Review allocations of indirect job costs.* Cost shifting is often hidden in the allocation of indirect costs, such as internally owned equipment costs, shop costs, insurance, and labor burden. Perform periodic tests to ensure that indirect costs are allocated properly to each job.
- *Perform a fade analysis.* Consider preparing two fade schedules. One schedule compares each job's prior period profitability estimate to the current estimate or actual results. The second schedule restates prior period uncompleted contract schedules using revised profitability figures. Each of these schedules will help you determine which contracts have had unusual fluctuations in profit.
- *Examine bid spreads.* You should compare your client's bid to the second place bidder and to the average bid of all of the bidders. If a contractor is more than 5 percent to 10 percent below other bidders, the contractor may realize little or no profit. Such a job is a prime candidate for cost shifting.
- *Compare profitability estimates to historical results.* A contactor may attempt to hide cost shifting by increasing profit estimates on uncompleted jobs. When this occurs, the gross profit percentages on uncompleted jobs will often exceed the contractor's historical results. You should also consider comparing uncompleted contract gross profit percentages to completed contract percentages.

Accounting Issues and Developments

Revenue Recognition

.84 As noted previously in this alert, SOP 81-1 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 the percentage-of-completion method will produce reasonably dependable estimates.

.85 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.

.86 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.

.87 In December 1999, the Securities and Exchange Commission (SEC), in an attempt to fill the gap in general revenue recognition guidance, released Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements.* SAB No. 101 was superseded by SAB No. 104, *Revenue Recognition*, in December 2003. Financial statement preparers and auditors of public construction companies are most directly affected by SAB No. 104. However, auditors of nonpublic companies may also find the information contained in SAB No. 104 useful. The issuance of SAB No. 104 did not affect the guidance for revenue recognition contained in SOP 81-1.

Recent Auditing and Attestation Pronouncements and Related Guidance

.88 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.89 The Public Company Accounting Oversight Board (PCAOB) establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review AICPA Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for periods beginning on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A), to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120);

Recent Auditing and Attestation Pronouncements and Related Guidance	
	• Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks; • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report.
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	See "AICPA Risk Assessment Standards" in this alert.
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue Date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) Issue Date: December 2005	SAS No. 103 supersedes SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) and amends AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1). Effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted, this SAS establishes standards and provides guidance to an auditor of a nonissuer on audit documentation.
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective for periods ending on or after December 15, 2006.

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325.01–.04), which interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.
Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330.01–.06), which interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.
AICPA TPA TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Recent Auditing and Attestation Pronouncements and Related Guidance	
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This practice alert responds to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.
AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This practice alert provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditor's report.

The Auditor's Communication With Those Charged With Governance

.90 In December 2006, the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and is effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to 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. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.91 SAS No. 114 recognizes the importance to the audit of effective two-way communication. It provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires significant matters communicated with those charged with governance to be documented.

Identifying Those Charged With Governance

.92 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those 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.

.93 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.94 Since there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.95 In May 2006, the AICPA ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. Among other things, SAS No. 112:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued, the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, AU sec. 320). However, with the adoption of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), the PCAOB redefined these terms, which now differ from SAS No. 112 does the following.

- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.

- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies and identifies indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.

- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.

- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.

- Contains illustrative written communications to management and those charged with governance.

How Revisions of SAS No. 112 Affect Practice

.96 As auditors gain a better understanding of what needs to be communicated to management and those charged with governance, there may be more control deficiencies that are identified as significant deficiencies and material weaknesses and that are then communicated to management and those charged with governance. Auditors may emphasize and therefore spend more time evaluating identified control deficiencies than in the past.

Discussions With Management and Others

.97 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. Auditors may have to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor who does not provide attest services for the client can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.98 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of material weaknesses. Another reason is that auditors have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in written communication as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.99 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented, detected, and corrected by the client.

Issues for Audits of Smaller Entities

.100 One issue that has arisen in audits of smaller entities is the increase in costs as a result of the time the auditor spends documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.101 Another issue that has caused concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, detecting, or correcting material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, because doing so would impair independence.[1] How an auditor responds to a client's internal control weakness, in terms of designing and

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[1] See Ethics Ruling 101-3, "Performance of nonattest services," of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.102 The requirements of SAS No. 112 introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing.

.103 The AICPA has published the AICPA Audit Risk Alert titled *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in implementation of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

AICPA Risk Assessment Standards

.104 In March 2006, the AICPA ASB issued eight SASs referred to as the risk assessment standards (SAS Nos. 104–111). Although the SASs include many of the underlying concepts and detailed performance requirements contained in existing standards, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risks of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between the risks, controls, audit procedures, and conclusions. The risk assessment standards are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier applications permitted. The following table lists the eight SASs and their effects on existing standards.

Statement on Auditing Standards	***Effect on Existing Standards***
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")* (AICPA, *Professional Standards*, vol. 1, AU sec. 230)	This statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230A).
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	This statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A).
SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)	This statement supersedes SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326A).
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)	This statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312A).

Statement on Auditing Standards	*Effect on Existing Standards*
SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)	This statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 310), and supersedes SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A).
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314)	This statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1, AU sec. 318)	This statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)	This statement amends SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350A).

Key Provisions of the Risk Assessment Standards

.105 Whether due to error or fraud, the new risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks that may lead to a material misstatement in the client's financial statements and any mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations of the Treadway Commission's framework, www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs will most likely result in significant changes to firm audit methodologies and the training of personnel. Therefore, it is recommended that auditors allow ample time in advance of the required implementation date. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Companion Audit Guide

.106 In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Audit Documentation Technical Practice Aids

.107 In May 2007, the ASB issued two Technical Practice Aid (TPA) Technical Questions and Answers (TIS) related to SAS No. 103, *Audit Documentation*, (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which was issued in December 2005.

.108 TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.109 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*), discusses whether the provisions of SAS No. 103 related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance*

.110 A key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.111 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date
- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.112 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf. Readers should also note the PITF is currently working on a practice alert that addresses auditing and other considerations related to electronic information that it plans to issue during the third quarter of 2007.

PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*

.113 In May 2007, the PCAOB adopted Auditing Standard No. 5, which was later approved by the SEC on July 25, 2007. This standard replaces Auditing Standard No. 2. Auditing Standard No. 5 is principles-based and presents a risk-based, top-down approach designed to increase the likelihood that material weaknesses will be found before resulting in a material misstatement of a company's financial statements, while eliminating unnecessary procedures. The standard was also designed to make audits more scalable for smaller or less complex companies. The PCAOB worked closely with the SEC to coordinate Auditing Standard No. 5 with the guidance to public company management that was approved by the SEC in May 2007. Mark Olson, PCAOB Chairman, stated "The new standard is more risk-based and scalable, which will better meet the needs of investors, public companies, and auditors alike."

.114 This new standard is required for all audits of internal control for fiscal years ending on or after November 15, 2007. However, early adoption is permitted and encouraged. For more information, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk).

Recent AICPA Independence and Ethics Pronouncements

.115 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.116 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions (FSPs) (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA Statement of Position (SOP) 07-1 (AICPA, *Technical Practice Aids*, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*

(continued)

Recent Accounting Pronouncements and Related Guidance	
TIS section 6140.20–.22 (AICPA, *Technical Practice Aids*, vol. 1) (Nonauthoritative)	These questions and answers discuss not-for-profit organizations fund-raising expenses.
TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various employee benefit plan topics.
TIS section 6300.25–.35 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various issues related to SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.117 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the construction 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. The AICPA general *Audit Risk Alert—2007/08* and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or go online at www.cpa2biz.com.

Fair Value Measurements

FASB Statement No. 157

.118 In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

.119 Prior to this statement, there were different definitions of fair value, and guidance for applying those definitions was dispersed among many accounting pronouncements. Difference in the existing guidance created inconsistencies that added to the complexity in applying generally accepted accounting principles (GAAP). FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. Readers can access the full text of FASB Statement No. 157 on the FASB Web site at www.fasb.org.

FASB Statement No. 159

.120 Subsequent to the issuance of FASB Statement No. 157, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value.

The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.121 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157. The choice to adopt early should be made within 120 days of the beginning of the fiscal year of adoption (for calendar year end entities, by April 2007), provided the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year of adoption. The FASB and SEC have expressed concern in the way some early adopters have applied the transition provisions of the standard. The AICPA Center for Audit Quality (CAQ) issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard such as this is applied in a good faith manner consistent with those objectives and principles. Specifically the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

On the Horizon

.122 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to the construction industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.123 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. 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 in addition to those discussed here. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Auditing Pipeline—Nonissuers

ASB Clarity Project

.124 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB approved for exposure a discussion paper titled *Improving the Clarity of ASB Standards*. This discussion paper seeks feedback on proposed changes to the standards, including:

- Establishing objectives for each of the standards, and the auditor's obligations related to the objectives
- Structural and drafting improvements to make the standards easier to read and understand
- Inclusion, in the explanatory material of the standards, of special considerations related to audits of public entities and small entities
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards

.125 The period to comment ended June 15, 2007. The discussion paper can be accessed at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

Convergence With International Standards

.126 The ASB has created a number of task forces charged with monitoring specific activities of the International Auditing and Assurance Standards Board (IAASB) and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of International Standards on Auditing (ISA). The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.127 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, the ASB previously decided to defer to issuance of a final revised AT section 501 until the

PCAOB issued its amendments and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www.aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*

.128 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards titled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA, *Professional Standards*, vol. 1, AU sec. 411]) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www.fasb.org. The ASB will issue its final SAS coincidentally with the FASB's and PCAOB's issuance of their final standards.

Auditing Pipeline—Issuers

.129 Guidance issued by the PCAOB is included in the section of this alert titled "Recent Auditing and Attestation Pronouncements and Related Guidance." For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), mentioned previously.

Accounting Pipeline

.130 Presented below are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year alert have not been finalized as of the date of this writing, and thus are included again.

Business Combinations

.131 Phase one of the business combination project resulted in the issuance of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*. In those statements, the FASB eliminated the use of the pooling of interests method of accounting for business combinations and addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. The objective of phase two of this project is to standardize business combination accounting through the convergence of the FASB and International Accounting Standards Board (IASB) accounting standards and by reconsidering the existing guidance for the purchase method of accounting for business combinations. Among the main proposals are the following:

- All acquisitions of businesses be measured at the fair value of the business acquired.
- Substantially all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.
- Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.132 In June 2005, the FASB and IASB issued a number of exposure drafts, for which comment periods ended in October 2005. Redeliberations began in January 2006 and were completed in June 2007. FASB and IASB expect to issue final statements during the fourth quarter of 2007. Four standards are expected to be issued:

- Proposed FASB Statement No. 141(R) and International Financial Reporting Standard (IFRS) No. 3(R), *Business Combinations*

- Proposed FASB Statement No. 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*

- Proposed International Accounting Standard (IAS) Statement No. 27(R)

.133 Readers should remain alert to the final issuances and visit the FASB Web site for further information.

Fair Value

.134 During phase one of the FASB's fair value option project, the FASB issued FASB Statement No. 159, which was previously discussed. In phase two of the project, the FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase two are expected to begin in the third quarter of 2007. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.135 In December 2006, the FASB issued an exposure draft titled *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure ended in March 2007, and the FASB has begun redeliberations to consider significant issues raised by respondents. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133 including how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entity's financial position, results of operations, and cash flows. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.136 The FASB is working on a project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, to address issues related to the permitted activities of a qualifying special-purpose entity (QSPE), isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, the FASB issued exposure draft, *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During 2007, the FASB expects to address issues related to the permitted activities of a QSPE and then issue another exposure draft during the fourth quarter of 2007 containing potential amendments to FASB Statement No. 140. See the FASB Web site for complete information.

Earnings Per Share

.137 The FASB and IASB have been working together to resolve differences between FASB Statement No. 128, *Earnings per Share*, and IAS Statement No. 33, *Earnings per Share*. This project is part of the larger FASB project, Short-term International Convergence, which has resulted in the issuance of a number of FASB Statements. Currently the FASB and IASB are addressing significant differences that remain relating to instruments that can be settled in cash or shares and are classified as a liability on an entity's balance sheet. The FASB and IASB are considering modifications to the treasury stock method and several scoping issues in which either the FASB and IASB has issued or may issue more detailed implementation guidance on earnings per share that may create a convergence difference. The FASB and IASB are expected to issue an exposure draft for public comment during the third quarter of 2007. This exposure draft will be the third exposure draft the FASB has issued on the earnings per share project. The project and current exposure draft can be reviewed on the FASB Web site.

FASB Codification and Retrieval Project

.138 The goal of this FASB project is to create a single, authoritative codification of U.S. GAAP. The codification will integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, EITF, and the SEC). The codification will have a three layered structure: topic, subtopic, and section. The FASB has structured the topics into three primary areas: overall presentation, transactional (or financial statement account), and industry. The overall presentation area addresses presentation of financial information but does not address items such as recognition, measurement, or derecognition. The transactional or financial statement account area addresses accounting recognition, measurement, or derecognition. The industry area includes guidance unique to the industry. A codification draft is expected in 2007 and will have an extended verification period to ensure that it accurately reflects U.S. GAAP. Once the FASB addresses respondent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards. Readers can track progress of the Codification and Retrieval Project on the FASB Web site at www.fasb.org/project/codification&retrieval_project.shtml.

GAAP Hierarchy

.139 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, which is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonissuers" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.140 ***Proposed FASB EITF Issues.*** Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.141 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

.142 The following are various resources that practitioners engaged in the construction industry may find beneficial.

Publications

.143 Practitioners may find the following publications useful with respect to the construction industry:

- Audit and Accounting Guide *Construction Contractors* (2007) (product no. 012587kk)
- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)

- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2007) (product no. 012517kk)
- Audit Guide *Audit Sampling* (2007) (product no. 012537kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2007) (product no. 012777kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- Audit Risk Alert *Compilation and Review—2007/08* (product no. 022308kk)
- Audit Risk Alert *Independence and Ethics—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Checklist Supplement and Illustrative Financial Statements for Construction Contractors* (product no. 008928kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.144 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, TPAs, 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.

Continuing Professional Education

.145 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191 [DVD]). 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.
- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

.146 Among the many courses, the following are specifically related to the construction industry:

- *Construction Contractors: Accounting Auditing and Tax* (product no. 736431kk). Master the fundamentals of the construction industry with this highly effective course. An outstanding value, it provides a thorough industry overview and includes AICPA authoritative publications. Content is tailored to the needs of both practitioners and industry financial professionals.

- *Construction Contractors Advanced Issues* (product no. 731993kk). Get hands-on advice on the accounting, audit, and tax issues that make the construction industry a high risk client. Address difficult issues such as look back calculations, measuring progress of construction contracts, and overhead allocations. Enhance your skills today to reduce the risk of your next construction engagement.

.147 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.148 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to the construction industry include the following:

- *Construction Contractors: Audit Risks in the Construction Industry*
- *Construction Contractors: The Industry and Its Accounting*
- *Construction Contractors: Sureties, Audit Planning and Preliminary Analytical Procedures*

.149 To register or learn more, visit www.cpa2biz.com.

Webcasts

.150 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.151 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.152 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.153 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.154 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. You can reach the Technical Hotline at (888) 777-7077.

Ethics Hotline

.155 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.

Industry Conference

.156 The National Construction Industry Conference is held in early winter in Las Vegas, NV. This conference is a two-day event for CPAs, CFOs, controllers, and members of the surety industry who serve the construction industry. It provides a national perspective from industry leaders about the latest construction industry trends and recent compliance issues. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA CAQ

.157 The CAQ (formerly the Center for Public Company Audit Firms) was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.158 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

Industry Web Sites

.159 The Internet covers a vast amount of information that may be valuable to auditors of construction companies, including current industry trends and developments. Some of the more relevant sites for auditors with construction clients include those shown in the appendix of this alert. The construction practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

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.160 This Audit Risk Alert replaces Construction Contractors Industry *Developments—2006/07*.

.161 The Audit Risk Alert *Construction Contractors Industry Developments—2007/08* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to ccole@aicpa.org or write to:

Christopher Cole, CPA CFE
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

.162

Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to auditors and accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, Practice Bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/ Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/ Accounting+and+Auditing/Audit+and+ Attest+Standards/Accounting+and+Review+ Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/ Accounting+and+Auditing/Audit+and+Attest + Standards/Professional+Issues+Task+Force
AICPA Governmental Audit Quality Center (GAQC)	Information and updates on the latest information relating to governmental auditing, particularly for audits performed under *Government Auditing Standards* and OMB Circular A-133	www.aicpa.org/GAQC
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
General Printing Office Access	Provides links to search the Code of Federal Regulations, Federal Register, and Public Laws	www.access.gpo.gov
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org

(continued)

Web Site Name	*Content*	*Web Site*
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov

[*The next page is 8311*.]

AAM Section 8100

Investment Companies Industry Developments—2007/08

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
INVESTMENT COMPANIES INDUSTRY DEVELOPMENTS—2007/08

This Audit Risk Alert is intended to provide auditors of financial statements of investment companies with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

Kenneth R. Biser, CPA, MBA
Technical Manager
Accounting and Auditing Publications

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your investment company audits. This alert can also be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory 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 financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The investment companies industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic, and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the entity's financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, GDP increased at an annual rate of 2.9 percent in 2006, consistent with the pace of growth experienced in 2005 when GDP increased by 3.1 percent. During the first quarter of 2007, GDP increased by an annual rate of only 0.6 percent. However, according to second quarter final estimates, GDP increased at an annual rate of 3.8 percent.

.11 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, with an annual average rate of 4.6 percent representing approximately 7 million people. The 2006 rates represent the lowest annual rate and total number of jobless since 2000, according to the U.S. Department of Labor, Bureau of Labor Statistics. During the first half of 2007, the unemployment rate averaged 4.5 percent. These data further demonstrate the economic growth the United States has experienced since the beginning of 2006.

.12 After a period of rising rates during the first half of 2006, the Federal Reserve kept its target for the federal funds rate at 5.25 percent for 10 consecutive meetings (June 2006–August 2007). At that time, the Federal Reserve indicated future federal fund rate adjustments would likely depend upon the outlook for economic growth and inflation. Since its August 2007 meeting and in response to shaky financial market conditions, the Federal Reserve has taken several action steps. It announced that it would provide reserves as necessary through the open market to facilitate the orderly functioning of financial markets by promoting trading in the federal funds market at rates close to the 5.25 percent target rate. On August 17, 2007, it announced that financial market conditions had deteriorated and tighter credit conditions and increased uncertainty have the potential to restrain economic growth. Then, at its September meeting, the Federal Reserve decided to lower its target for the federal funds rate 50 basis points (bp) to 4.75 percent citing increased uncertainty surrounding the economic outlook. The Federal Reserve also decided to decrease the discount rate 50 bp to 5.25 percent to consistently keep the spread between the primary credit rate and the target federal funds rate at 50 bp. Auditors should remain alert to developments in the financial markets and how they may affect your audit engagements.

Industry Trends and Conditions

Subprime Trends and Events

.13 On May 17, 2007, Ben S. Bernanke, chairman of the Board of Governors of the Federal Reserve System, commented that the rise in delinquencies among subprime adjustable rate mortgages was due to several causes. These causes include rising interest rates, moderate economic growth, decline in the housing market, and regional economic problems.

.14 Bernanke noted that the practices of several mortgage originators to loosen underwriting standards contributed to the problems in the subprime market. As the underlying pace of mortgage originations slowed, the demand for securities with high-yield rates strengthened and some lenders loosened underwriting standards. The loosened standards undoubtedly contributed to defaults occurring within a few months of origination. Bernanke explained that mortgages sold generally pass a large amount of risk to the investor, rather than being borne primarily by the company that originated the loan, which may have contributed to the loosening of underwriting standards. In addition to weakened standards, incentive structures that tied originator revenue to the number of loans finalized, rather than the quality of loans made, are also a cause for concern.

.15 Despite subprime woes, Bernanke indicated that the market had shown signs of self-correction. While credit spreads on new subprime securities have risen, the volume of subprime-mortgage-backed securities issued has slowed. That does not mean, however, that the subprime market has evaporated. While some subprime lenders have gone out of business, other entities, such as hedge funds and investment banks, have started to purchase subprime-mortgage-backed securities. Importantly, Bernanke pointed out that the majority of troubled lenders have not been institutions with federally maintained deposits.

.16 The repercussions of these events continue to be felt in the financial markets. Liquidity in the market for subprime-mortgage-backed securities has deteriorated significantly since early July, when the major rating agencies began to downgrade subprime mortgage ratings on a number of issues, including the increased numbers of delinquencies and foreclosures. Additionally, a number of highly leveraged hedge funds (and other investment vehicles) breached various borrowing and margin covenants, which resulted in portfolio liquidations both of subprime-asset-backed securities and, at times, other unrelated investments. Price quotations for subprime-asset-backed securities have become increasingly difficult to obtain and, when obtained, exhibit wide, bid-asked spreads. Further, actual transactions periodically occur at values significantly different from quoted prices, due both to the general market illiquidity and the presence of distressed sellers.

.17 One major spillover effect of these events has been in the market for short-term commercial paper, particularly securities backed by various financial assets. Some of this paper, issued by structured investment vehicles (SIVs), other *conduit* structures, and hedge funds, was supported, in part, by subprime mortgage securities. The paper was rated investment grade because the value of the collateralizing securities was significantly higher than the outstanding debt. In some cases, the deterioration in the subprime market caused this *overcollateralization* to be reduced below the levels permitted under the commercial paper issuance program, resulting in the unexpected extension of maturities or the repayment of maturing paper through drawdowns on bank lines of credit because the issuers could not sell new paper on the market. The resulting uncertainty about these issuers' outstanding commercial paper, and the potential for other issuers to encounter the same difficulties, caused the market for asset-backed commercial paper to exhibit many of the same signs of illiquidity apparent in the subprime market. In some cases, issuers who had not breached covenants, but were perceived as having some of the same risk characteristics of troubled issuers, had difficulty selling commercial paper. (This broader market illiquidity was one reason for the decrease in the discount rate mentioned earlier.)

.18 Various money market funds (both registered and unregistered) have acknowledged investments in troubled paper. They have enhanced their monitoring procedures of differences between net asset value as determined using amortized cost and market values of securities, as required by Rule 2a-7 under the Investment Company Act of 1940 or other equivalent regulations.

.19 More generally, these events have caused what has been termed a *repricing of risk* in the financial markets. The spreads over riskless rates on high-yield bonds and loans have increased and there have been reports that proposed leveraged buyouts of industrial companies have had to accept higher borrowing costs and stricter financial covenants in order to bring the transactions to completion. Further, it has been reported that several major investment banks have had significant difficulty selling to third-party interests to complete recent transactions that had lower yields and more generous financial covenants.

.20 Auditors should be aware of the increased risk posed by current market conditions and develop or modify audit procedures accordingly. Among other things, auditors may consider:

- The overall effect on risk of an entity's portfolio of subprime mortgages and related investments (for example, asset-backed commercial paper or high-yield debt or loans). The auditor may consider the entity's internal controls, as well as policies that affect the management and monitoring of these investments. In particular, the auditor may consider the extent to which the entity analyzes the collateral supporting various asset-backed securities and whether the entity has enhanced its monitoring procedures in light of the deterioration in collateral that has been exhibited.

- The increased difficulty of obtaining reliable valuations for certain types of asset-backed securities, given the decrease in market liquidity. Again, the auditor may consider the entity's internal controls over valuation, in particular the extent to which it monitors valuations obtained from brokers and external pricing services for consistency with its own observations of market conditions, as well as the involvement of valuation committees or other internal review groups independent of portfolio managers in assessing the day-to-day reasonableness of security valuations and overriding quotations that appear to be unrepresentative. This is of equal importance for money market funds that are permitted to use the amortized cost valuation method only if the results are not materially different from those obtained by valuing securities using current market quotations.
- The existence of financial covenants within the vehicle and its compliance with those covenants to the extent an investment vehicle has employed leverage. The auditor may obtain an understanding of management's ongoing compliance monitoring process. If the vehicle is no longer in compliance with the covenants, the auditor should assess the appropriate accounting and reporting implications, including AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1).

.21 In certain instances, the auditor may need special skills or knowledge to plan and perform auditing procedures for institutions that deal with subprime-mortgage-backed securities. AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1), states that for some derivatives and securities, generally accepted accounting principles (GAAP) may prescribe presentation and disclosure requirements. Furthermore, AU section 332 advises the auditor to consider the form, arrangement, and content of the financial statements (including the notes) when evaluating the adequacy of presentation and disclosure. Auditors may also consider using a specialist when determining how to audit an entity that deals in derivatives. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance on the use of a specialist during an engagement.

Impact on Investment Companies

.22 As a result of the conditions in the subprime markets, several business and accounting issues arise, many of which relate to the measurement of the fair value of securities in the current illiquid market and the devaluation of commercial paper or other securities in money market funds or held as collateral for security lending transactions. Moreover, pricing services, such as Interactive Data Pricing and Reference Data, have issued press releases to inform users that they are experiencing difficulties in obtaining a typical amount of consistent market information in the production of valuations of subprime-related securities. Therefore, certain investment companies have enhanced their procedures to respond to these issues including, among other things, more frequent shadow pricing in money market funds and close monitoring of the portfolios for exposure to these markets and the associated valuations of these securities.

.23 Accordingly, auditors should consider the procedures and controls put in place by management to identify problem credits and pricing concerns; validate the reliability of pricing or institute fair-value procedures, or both, if necessary; monitor the collectibility of accrued income; and modify reporting and disclosures based on the exposure of these markets in their funds. Auditors should also consider the need to enhance audit procedures to ensure prices obtained from pricing services are reasonable, including the use of multiple pricing sources or valuation experts to review any pricing models or fair value methodologies put in place, or both. Auditors' procedures need to be flexible to respond to changes in the market conditions.

Beyond Subprime

.24 There is growing speculation that the problems and risks associated with subprime mortgages may spread to other financial transactions. According to a June 25, 2007 article in the *Wall Street Journal*, entitled

"Beyond Subprime, Risks Abound," the bond market is one industry that is already feeling the pressure from subprime mortgages. According to Emerging Portfolio Fund Research Global, investors pulled more than $1 billion out of high-yield bond funds in the two weeks leading up to the June 2007 article. Another concern is the way adjustable rate mortgages will react as subprime woes continue to trickle down the mortgage industry.

Legislative and Regulatory Developments

SEC Division of Investment Management Responds to Fund's Use of Rule 22c-2 Information for Marketing Purposes

.25 The Securities and Exchange Commission (SEC) Division of Investment Management recently responded to funds use of Rule 22c-2 information for marketing purposes. Rule 22c-2, adopted by the SEC in 2005 and amended in 2006, requires financial intermediaries to provide certain shareholder identity and trading information to investment companies for the purpose of monitoring prohibited market-timing trading activity. The rule became effective October 16, 2007. In general, the privacy rules under the Gramm-Leach-Bliley Act require financial institutions, including investment companies, to provide consumers with notice and an option to opt out before institutions are permitted to share nonpublic consumer information with intermediaries. There are two exceptions to the rule: processing and servicing transactions made at the consumers' request and complying with applicable legal requirements. The use of any Rule 22c-2 information obtained by investment companies under an exception is limited to the specified purpose. The SEC reminded investment companies that use of the information for other purposes is expressly forbidden under the Gramm-Leach-Bliley Act's privacy rules, unless the intermediaries' consumers have been given notice and the opportunity to opt out of the information sharing process. The SEC's statement is available at www.sec.gov/divisions/investment/guidance/ici082107.pdf.

SEC Adopts New Fund of Funds Rules Under the Investment Company Act of 1940

.26 In June 2006, the SEC issued final amendments to rules adopted under Section 12(d) of the Investment Company Act of 1940 (the 1940 Act). New Rules 12d1-1, 12d1-2, and 12d1-3 became effective July 31, 2006 and, among other things, permit the adoption of cash-sweep arrangements in which a fund may invest available cash in a money market fund, permit a fund investing in other affiliated funds also to hold direct investments in any other securities, and broaden limits on sales loads charged by a registered fund investing in shares of other funds that themselves are subject to sales loads. The SEC also adopted amendments to Forms N-1A, N-2, N-3, N-4, and N-6, effective with new registration statements filed on or after July 31, 2006 and annual updates to registration statements filed on or after January 1, 2007, to require disclosure of expenses of acquired funds that investors in an acquiring fund will bear indirectly. See SEC Release No. 33-8713 under the Securities Act of 1933 and Release No. IC-27399 under the 1940 Act for more information. The required registration statement expense disclosures do not affect the presentation of expenses or expense ratios in financial statements.

.27 In May 2007, the SEC Division of Investment Management staff released guidance, in a question-and-answer format, about certain issues raised in connection with the disclosure amendments referred to above. These responses can be obtained from the SEC's Web site at www.sec.gov/divisions/investment/guidance/fundfundfaq.htm.

New Rules Permitting SEC Enforcement Action for Fraud by Advisers to Unregistered Investment Vehicles

.28 In August 2007, the SEC adopted a new rule under the Investment Advisers Act of 1940 prohibiting advisers for pooled investment vehicles from making false or misleading statements to, or otherwise defrauding, investors or prospective investors in those vehicles. The SEC would be able to bring action under these rules even if the adviser or the pool was not registered with the SEC. The intent of the rule was to clarify the SEC's ability to bring enforcement actions against advisers for defrauding investors or prospective investors in light of a 2006 court decision overturning rules that would have required registration with the SEC of certain advisers to unregistered investment pools. In that decision, the court ruled that, for purposes of the Investment Advisers Act, the term *client* referred to the pool, not the investors in the pool, making it unclear whether the SEC's jurisdiction extended to fraud against pool investors.

Data Tagging of Prospectus Risk/Return Summary Information

.29 In July 2007, the SEC adopted rule amendments to extend its current program to voluntarily submit financial information tagged in eXtensible Business Reporting Language (XBRL) format to the risk/return information contained in mutual fund prospectuses. The risk/return summary data may be filed by any mutual fund without SEC preapproval simply by submitting the information in the required manner as an attachment to the related filing on the SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system. The goal of this amendment was, as stated in the SEC's adopting release, to "help to streamline the delivery of mutual fund information and provide investors, analysts, and others with improved tools to compare funds based upon, among other things, costs, investment objectives, strategies, and risks." The amendments became effective August 20, 2007. The release is available from the SEC's Web site at www.sec.gov/rules/final/2007/33-8823.pdf.

Short Selling Amendments

.30 In August 2007, the SEC issued a final rule *Amendments to Regulation SHO*, (Release No. 34-56212), which amends the regulation of the same name. The amendments are intended to reduce the number of persistent fails to deliver certain equity securities by eliminating the grandfather provision of Regulation SRO. Additionally, the SEC is also amending the close-out requirement of the regulation that a seller is "deemed to own" (related principally to securities at one time subject to SEC Rule 144). Lastly, the amendments update the market decline limitation referenced in the regulation. This final rule became effective October 15, 2007.

.31 During the same time, the SEC adopted amendments to Regulation M (Release No. 34-56206) to further safeguard the integrity of the capital-raising process and protect issuers from manipulative activity that can reduce an issuer's offering proceeds and dilute security-holder value. The amendments are designed to eliminate the covering element of the former rule in order to prevent strategies designed to conceal the covering of short sales with offered securities in the restricted period surrounding an offering. This final rule became effective October 9, 2007.

Reporting Emphasis-of-a-Matter Paragraph

.32 As a general rule, the more complex or illiquid the investments, the greater the inherent uncertainty in their fair value and the more likely fair values are to be based on management's estimates. As the inherent uncertainty in the estimate increases, as well as the significance of such investments to the financial statements, auditors may consider inclusion of an emphasis-of-a-matter paragraph in the auditors' report, such as the following example provided in *Alternative Investments Audit Considerations: A Practice Aid for Auditors*, issued by the AICPA in 2006, tailored for the specific facts and circumstances:

> "As explained in note X, the financial statements include investments valued at $ _______ (____ percent of net assets), whose fair values have been estimated by management in the absence of readily determinable fair values. Management's estimates are based on information provided by the fund managers or the general partners."

.33 As noted in the practice aid, "An emphasis of matter paragraph is not used to introduce information to the financial statements and neither replaces any required financial statement note disclosure nor reduces the required audit evidence needed to support an unqualified opinion. Such paragraphs are never required and are included solely at the auditor's discretion. The above emphasis of matter paragraph would be consistent with GAAP disclosures made in the financial statements."

.34 A question has arisen as to the extent the auditor could include an emphasis-of-a-matter paragraph in a filing with the SEC when a registrant had invested in alternative investments subject to the practice aid's scope. The SEC has confirmed that they will emphasis-of-a-matter paragraph paragraph as an element of an unqualified opinion on financial statements. An emphasis of matter paragraph is considered unqualified and should not be used in circumstances where a qualified opinion, or disclaimer of opinion due to a scope limitation, is otherwise appropriate. SEC Accounting Series Release No. 118 (Financial Reporting Practices No. 404.03.e) appeared to permit the use of such an emphasis paragraph, at least for filings with the SEC's Division of Investment Management; however, this release, issued in 1970, presented the emphasis paragraph as a *subject to* opinion, which was subsequently prohibited under generally accepted auditing standards (GAAS).

Financial Industry Regulatory Authority—A New Regulatory Organization

.35 Effective July 30, 2007, the regulatory arms of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) have merged into an agency named Financial Industry Regulatory Authority (FINRA). The creation of FINRA affects many different aspects of the securities industry, such as education, examinations, and registration of securities. FINRA is also dedicated to investor protection and market integrity through effective and efficient regulation and complementary compliance and technology-based services. For more information on FINRA, please visit their Web site at www.finra.org.

Agencies Release Revised Bank Secrecy Act/Anti-Money Laundering Examination Manual

.36 On August 24, 2007, the Federal Financial Examination Council released the revised Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual (manual). The revised manual reflects the commitment of federal and state banking agencies and the Financial Crimes Enforcement Network to provide consistent guidance on risk-based policies, procedures, and processes for banking organizations to comply with the BSA and safeguard operations from money laundering and terrorist financing. The 2007 edition clarifies supervisory expectations since the July 28, 2006 update.

Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards

.37 In August 2007, the SEC published the *Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards* (available at www.sec.gov/rules/concept/2007/33-8831fr.pdf) to obtain information about the extent and nature of the public's interest in allowing U.S. issuers of financial statements, including investment companies subject to the Investment Company Act of 1940, to prepare financial statements in accordance with International Financial Reporting Standards (IFRS) as published by the International Accounting Standards Board (IASB), while still complying with the rules and regulations of the SEC.

.38 Currently, U.S. issuers prepare their financial statements in accordance with GAAP. Under GAAP, there are some unique disclosure requirements for investment company financial statements. For example, Regulation S-X contains specific disclosure requirements for investment companies that have investments in unaffiliated issuers, investments in affiliates, securities sold short, open option contracts written, and investments other than securities.[1] Rule 6-05 of Regulation S-X permits investment companies to include a Statement of Net Assets in lieu of the balance sheet if at least 95 percent of the investment company's total assets are represented by investments in securities of unaffiliated issuers. The nonfinancial statement portion of an investment company's shareholder report may require disclosures that are based on financial statement information. For example, investment companies must include an expense table and a graphical

[1] See Rules 12-12 through 12-14 of Regulation S-X [17 CFR 210.12-12, 12-12A, 12-12B, 12-12C, 12-13 and 12-14].

representation of holdings.[2] Differences between IFRS and GAAP often result in different financial statement presentations. For example, IFRS do not require a schedule of investments or financial highlights; however, GAAP requires this information as part of an investment company's financial statements. Another example, the IFRS do not provide an exemption from consolidation of subsidiaries in an investment company, whereas GAAP provides exemptions from consolidating subsidiaries in certain areas, which could result in different treatment for master-feeder funds.[3]

.39 In July 2007, the SEC proposed to accept financial statements from foreign private issuers prepared in accordance with IFRS as published by the IASB without reconciliation to GAAP. To implement this, the SEC proposed to amend Form 20-F and change Regulation S-X to accept financial statements prepared in accordance with the English language version of IFRS, as published by the IASB without reconciliation to GAAP. In light of the ongoing convergence efforts of the IASB and the Financial Accounting Standards Board (FASB) and the movement outside the United States towards accepting financial statements prepared in accordance with IFRS, the SEC was seeking input on the concept release regarding the role of IFRS as published by the IASB as a basis of financial reporting in the U.S. public capital market by U.S. issuers. Comments were due November 13, 2007.

SEC Staff Reviews of Financial Statements

.40 **Disclaimer:** A summary of financial statement review comments issued by the SEC staff (the staff) to investment company registrants and other guidance related to issues encountered by SEC registrants follows. These comments were compiled by the AICPA Investment Companies Expert Panel and have not been approved or endorsed by the SEC or its staff.

.41 *Receivables from advisors*. The staff noted instances when amounts due to the fund from its investment advisor or other related party are not settled in a timely manner. The staff expects the receivable balance to settle with the same frequency as the advisor receives its fees (typically monthly). The staff also expects receivable balances from other related parties to settle in a similar manner. The staff expressed concern that some advisors may not have the ability to settle large outstanding receivable balances on the fund's books. The fund should not consider the receivable balance collectible to the extent that collection of some of the amount may be in doubt.

.42 *Fund marketing materials*. The staff expressed concern about instances when fund marketing materials on the registrant's Web site are not consistent with information submitted in SEC filings, such as registration or financial statements.

.43 *Expense recaptures and investment companies registered under the Investment Company Act of 1940*. The staff noted some instances when registered funds inappropriately recaptured expenses that were previously waived or reimbursed. For example, assume a fund with a December 31 fiscal period establishes an expense cap of 50 bp for the period from January 1 through June 30. Effective July 1, the fund increases it expense cap to 100 bp and applies the revised cap through December 31. It would be inappropriate for a fund to record expenses during the period from July 1 to December 31, that relate to the period prior to June 30 as a result of the rate of actual expenses being incurred being less than 100 bp, but greater than 50 bp. The staff believes that all expenses and waivers need to be tracked separately. The staff also believes that recapture between different expense cap thresholds is inappropriate.

.44 *Overaccrual of distribution fees*. Distribution fees (otherwise known as 12b-1 fees) are fees paid by the fund out of fund assets to cover the costs of distribution and shareholder service expenses. The term 12b-1 fees is derived from the SEC rule that permits such payments. A 12b-1 plan may be established as a fee

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[2] See Items 22(d)(1) and (2) of Form N-1A.

[3] A master-feeder fund is a two-tiered arrangement in which one or more *feeder* funds hold shares of a single "master" fund in accordance with Section 12(d)(1)(E) of the Investment Company Act of 1940.

payable by the fund, based on an annual percentage of the fund's average net assets (a compensation plan) or based on an annual percentage of the fund's average net assets limited to actual costs incurred, after deducting contingent deferred sales loads received by the distributor (a reimbursement plan). Therefore, a compensation plan differs from a reimbursement plan because the latter provides for annual or cumulative limits on fees paid. Fees for both kinds of plans are treated as expenses in a fund's statement of operations.

.45 During an examination by the Office of Compliance Inspections and Examinations, the staff noted that a registrant had implemented a reimbursement 12b-1 plan, but had recorded distribution expenses in excess of the amount required to reimburse the distributor for the costs of distribution. As a result of this accrual, the net asset value per share was understated by the amount in excess of the amount required for reimbursement. It is incumbent on the fund and its distributor to have sufficient controls and procedures established to ensure the fund would not be charged an amount in excess of that due under the plan.

.46 *Failure to keep books and records and support investment valuations.* The SEC took enforcement action against a closed-end management investment company for violation of record keeping and internal control provisions of federal securities laws. The enforcement action was brought against the company because of failure to value certain securities in its private finance portfolio for which market quotations were not readily available. Because the company did not make or maintain books, records, and accounts in reasonable detail, they could not support or fairly reflect portfolio valuations. In addition, the company's internal controls failed to provide a reasonable assurance that the company valued these securities in accordance with GAAP.

.47 The company did not provide its board of directors with sufficient contemporaneous valuation documentation during the quarterly valuation processes. In some circumstances, investment values were listed on worksheets without explanation of necessary inputs or calculations. In other instances, the company changed key assumptions, valuation methods, or both when compared to prior periods without any documentation supporting such change. Finally, the company did not maintain, in reasonable detail, written documentation to support the value of certain portfolio investments that had gone into bankruptcy.

.48 Registrants should devise and maintain a system of internal controls sufficient to provide a reasonable assurance that recorded valuations comply with applicable securities laws and are consistent with GAAP. This includes periodically providing an entity's board of directors with appropriate documentary evidence to facilitate the determination of fair value of portfolio securities.

.49 *Expense tables and capitalization tables in the multifund mergers involving two or more target funds.* Item 3 of Form N-14 requires the registration statement of merging investment companies to include a table showing the current fees for the registrant and the company being acquired and any pro forma fees, if different, for the registrant after giving effect to the transaction. Item 4 of Form N-14 requires that the registrant furnish existing and pro forma capitalization amounts. Historically, registrants have disclosed multiple fee tables and capitalization tables for all combinations. Disclosing every combination of pro forma fee tables and capitalization tables may be voluminous and difficult for shareholders to understand. If registrants believe that alternative presentations of fee tables and capitalization tables are warranted, the staff recommends that registrants consult their examiner.

.50 *Periods presented for depositors filing financial statements prepared in accordance with statutory accounting principles contained in insurance product registration statements.* Items 23, 24, and 28 of Forms N-3, N-4, and N-6 permit depositors to file financial statements prepared in accordance with statutory accounting principles in lieu of GAAP if the depositor has no other reason to prepare GAAP financial statements except for use in its registration statement (the Statutory Exception). The instructions pertaining to depositor financial statements require depositors to include financial statements and schedules required by Regulation S-X. Rule 3-02, *Consolidated Statements of Income and Changes in Financial Position of Regulation S-X*, requires, among other things, audited consolidated statements of income and cash flows for each of the last three fiscal years. However, the staff discovered that some depositors, relying on the Statutory Exception, presented these statements and the statements of changes in capital and surplus for two years in their annual updates to the insurance products registration statement. The staff reminds registrants that Rule 3-02 of Regulation S-X applies equally to all depositors, regardless of the basis of accounting used to prepare the depositor's financial statements. Depositors relying on the Statutory Exception are required to include statements of income, cash flows, and changes in capital and surplus for the last three years when updating their registration statements.

Audit and Attestation Issues and Developments

Report on Internal Control Required by the SEC Under Form N-SAR

.51 The Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), which was then approved by the SEC on July 25, 2007. Aspects of guidance in this standard also apply to the consideration of internal controls in financial-statement-only audits of issuers subject to PCAOB standards. Such consideration should include the review, study, and evaluation of the financial reporting information system and internal control over financial reporting, including control activities for safeguarding securities, as required by the instructions for Form N-SAR. Among other things, Auditing Standard No. 5 modified the definitions of *material weakness* and *significant deficiency* to be used in the audits of issuers' financial statements under PCAOB standards. The Form N-SAR report should reflect any material weaknesses present as of the fiscal year-end date. Although Auditing Standard No. 5 is effective for reports issued for fiscal years ending after November 15, 2007, independent registered public accounting firms are encouraged to apply it immediately because Auditing Standard No. 5 guidance can be used for reports due on or after August 27, 2007. A copy of the N-SAR letter is posted at the following Web site: thecaq.aicpa.org/Resources/Auditing/Investment+Companies+Expert+Panel+Issues+Revised+N-SAR+Letter.

Investment Company Technical Practice Aids

.52 Recently, the AICPA issued four Technical Practice Aid (TPA) Technical Questions and Answers (TIS) related to investment companies. TIS section 6910, "Investment Companies" (AICPA, *Technical Practice Aids*, TIS sec. 6910.21-.24), present answers to various questions that auditors may have when conducting an audit of financial statements of investment companies. Recognition of premiums and discounts on short positions in fixed-income securities, presentation of reverse repurchase agreements, accounting treatment of offering costs incurred by investment partnerships, and the meaning of "continually offer interests" are covered in these questions and answers. Additional information is available at www.aicpa.org/download/acctstd/final_IC_TPAs.pdf.

Alternative Investments—Audit Considerations

.53 Due to the risk of misstatement inherent with alternative investments, the Audit Issues Task Force of the Auditing Standards Board (ASB) established the Alternative Investments Task Force. This task force was charged with providing additional guidance to auditors of investor entities as to how the auditor may obtain sufficient and appropriate audit evidence in order to conclude that financial statements are free of material misstatement. The Alternative Investments Task Force developed and issued a technical practice aid, entitled *Alternative Investments Audit Considerations: A Practice Aid for Auditors*, which provides guidance on:

- General considerations pertaining to auditing alternative investments
- Addressing management's financial statement existence assertion
- Addressing management's financial statement valuation assertion
- Management representations

.54 For more information, please visit www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/alternative_investments.

Accounting Issues and Developments

Fair Value Measurements

Financial Accounting Standards Board Statement No. 157

.55 In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements*, to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

.56 Prior to this statement, there were different definitions of fair value and guidance for applying those definitions was dispersed among many accounting pronouncements. Differences in the existing guidance created inconsistencies that added to the complexity in applying GAAP. FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. Readers can access the full text of FASB Statement No. 157 on the FASB Web site at www.fasb.org.

.57 Some of the issues faced by investment companies for implementing FASB Statement No. 157 are that:

- Investment companies must obtain necessary information from pricing services and dealers to understand the inputs used in determining fair values, so that the investment company may properly categorize such valuations in Level 1, 2, or 3.
- Investment companies may no longer use block discounts upon the adoption of FASB Statement No. 157.
- The preparer must determine whether restrictions are entity- or security-specific for purposes of determining whether a related discount is appropriate (discounts are only appropriate if the restriction is an attribute of the security).
- An investor's proportionate share of the net asset value of an investment company may not represent fair value under the guidance in FASB Statement No. 157. An investor may need to consider other rights or obligations attached to his or her investment in the investment company (for example, liquidity restrictions) that may impact a market participant's determination of fair value in a negotiated transaction.

.58 Once an entity adopts FASB Statement No. 157, the SEC staff believes that N-Q filings made by registered investment companies should include disclosures required by FASB Statement No. 157. Inclusion of the disclosures in fund N-Q filings will enhance the ability of financial statement readers to compare the liquidity of the fund investments from quarter to quarter and will provide meaningful background information about fund holdings.

FASB Statement No. 159

.59 Subsequent to the issuance of FASB Statement No. 157, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159

allows entities to choose to measure many financial instruments and certain other items at fair value. The statement permits an entity to elect the fair value option on an instrument-by-instrument basis and, once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.60 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, with early adoption permitted, provided the entity also elects to apply the provisions of FASB Statement No. 157. The choice for early adoption should be made within 120 days of the beginning of the fiscal year of adoption (by April 2007 for calendar-year-end entities), provided the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year of adoption. The FASB and SEC have expressed concern in the way some early adopters have applied the transition provisions of the standard. The AICPA Center for Audit Quality (CAQ) issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard such as this is applied in a good faith manner consistent with those objectives and principles. Specifically, the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

Statement of Position 07-1, *Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*

.61 In June 2007, the Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 07-01, *Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* (AICPA, *Technical Practice Aids*, ACC sec. 10,930). This SOP provides guidance for auditors when trying to determine whether an entity is within the scope of the AICPA Audit and Accounting Guide, *Investment Companies*. In addition, the SOP also modifies FASB Emerging Issues Task Force (EITF) Issue No. 85-12 by establishing conditions for the retention of investment company accounting by parent companies in consolidation with equity-method investors and requiring various disclosures if investment company accounting is retained. The SOP is effective for fiscal years beginning on or after December 15, 2007, with earlier application encouraged. (**Note:** Readers should be advised that FASB is considering delaying the effective date of SOP 07-01. Readers should consult the FASB Web site for further information.)

.62 AcSEC has proposed a set of nonauthoritative TPAs intended to clarify various issues found in SOP 07-01. Readers should monitor the progress of these practice aids as they are expected to be finalized prior to the effective date of the SOP.

FASB Interpretation No. 48

.63 FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

.64 The evaluation of a tax position in accordance with this interpretation is a two-step process. The first step is recognition. The enterprise determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. In evaluating whether a tax position has met the more-likely-than-not recognition threshold, the enterprise should presume that the position will be examined by the appropriate taxing authority that would have full knowledge of all relevant information. The second step is measurement. A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

.65 Differences between tax positions taken in a tax return and amounts recognized in the financial statements will generally result in one of the following:

a. An increase in a liability for income taxes payable or a reduction of an income tax refund receivable

b. A reduction in a deferred tax asset or an increase in a deferred tax liability

c. Both (a) and (b)

.66 An enterprise that presents a classified statement of financial position should classify a liability for unrecognized tax benefits as current to the extent that the enterprise anticipates making a payment within one year or the operating cycle, if longer. An income tax liability should not be classified as a deferred tax liability unless it results from a taxable temporary difference (that is, a difference between the tax basis of an asset or a liability as calculated using this interpretation and its reported amount in the statement of financial position). This interpretation does not change the classification requirements for deferred taxes.

.67 Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. Use of a valuation allowance as described in FASB Statement No. 109 is not an appropriate substitute for the derecognition of a tax position. The requirement to assess the need for a valuation allowance for deferred tax assets based on the sufficiency of future taxable income is unchanged by this interpretation.

FASB Staff Position FIN 48-1, Definition of Settlement in FIN 48

.68 On May 2, 2007, the FASB issued FASB Staff Position (FSP) FIN 48-1, *Definition of Settlement in FIN 48*. This FSP amends FIN 48 to provide guidance on how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits.

.69 The FSP amends FIN 48 to clarify that a specific tax position could be considered *effectively settled* for a particular tax year upon conclusion of an examination by a taxing authority, the entity does not intend to challenge any aspect of a position included in the examination, and it is remote that the authority would examine or re-examine any aspect of the tax position, even if the particular tax position was not examined in that year. Assessing whether a tax position is effectively settled is a matter of judgment. When making a settlement determination, an enterprise should make a position-by-position assessment for all positions in a particular tax year. The FSP, however, makes it clear that effective settlement of a position in a year that has been examined does not result in effective settlement of similar or identical positions in periods that have not been examined.

.70 The guidance outlined in the FSP shall be applied upon the initial adoption of FIN 48. An enterprise that applied FIN 48 in a manner consistent with the provisions of this FSP would continue to apply the provisions in this FSP from the date of initial adoption of FIN 48. An enterprise that did not apply FIN 48 in a manner consistent with this FSP is required to retrospectively apply the provisions in this FSP to the date of the initial adoption of FIN 48.

SEC Division of Investment Management Staff FIN 48 Implementation Guidance

.71 On December 22, 2006, the staff of the SEC's Division of Investment Management issued a letter to the Investment Company Institute on the implementation of FIN 48 by registered investment companies. In that letter, the staff made the following observations:

- The staff expressed its belief that FIN 48 "places [no] limits on the type of evidence that an enterprise can look to in making its determination of the technical merits of a tax position," and that a registered investment company may consider "less formal forms of guidance from [a] taxing authority," weighing "all available forms of evidence based on their persuasiveness."

- The staff also observed that "the administrative practices and precedents of [a] taxing authority should be considered in the fund's analysis" as to whether a tax position meets FIN 48's recognition threshold, including any practice, to the extent such exists, of addressing industry taxation issues on a prospective basis.

- The staff further stated that it would not object to a registered investment company implementing FIN 48 for purposes of its computation of net asset value (NAV) "as late as its last NAV calculation in the first required financial statement reporting period for its fiscal year beginning after December 15, 2006." For example, the staff noted that a fund with a December 31 fiscal year end could implement FIN 48 no later than its June 29, 2007 NAV calculation, which is the last calculation immediately preceding the first semiannual period for which the fund would be required to file complete financial statements on Form N-CSR. This deferral relates only to NAV computations and does not affect the financial statement implementation date prescribed by FIN 48.

.72 Separately, on June 28, 2007, the Division of Investment Management staff responded to a request for two specific additional clarifications submitted by several investment company complexes as follows:

- The staff expects the guidance of FIN 48, not the standard for recognizing contingent liabilities stated in FASB Statement No. 5, *Accounting for Contingencies,* to be applied in the determination of daily net asset values for purposes of share transactions. The staff further noted that, while it would not expect an issue to be fully evaluated within a single business day, it also would not establish a "safe harbor" minimum number of days for evaluation. Rather, it expects investment companies to apply "reasonable diligence" in gathering information and subsequently evaluating uncertain tax positions that may be identified, with interim net asset value determinations to be based on management's best judgment based on information available at the time.

- In certain instances, advisers or other third parties have indemnified funds for exposures to tax uncertainties that have been or may be asserted by taxing authorities. The staff stated that a past practice of indemnification alone was an insufficient basis to record a potential reimbursement for uncertainties that may be identified under FIN 48; rather, a written reimbursement agreement was required. However, the staff also observed that the indemnification may be recognized (and derecognized upon "effective settlement") to the same amount and extent as a liability related to the uncertain tax position is recorded under FIN 48.

.73 To help financial statement preparers, auditors, and tax advisers meet this new requirement, the AICPA developed a *Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48*. Tax positions can only be recognized if they meet a more-likely-than-not threshold of being realized if challenged by a taxing authority with full knowledge of the facts. If this level of certainty is not met, no tax benefit can be recorded and, even if it is met, only the amount that has a greater than 50 percent chance of being sustained may be booked. Specific financial statement disclosures are required with respect to uncertain tax positions. The practice guide includes highlights of FIN 48 and its implications for in-house accountants, auditors, and tax advisers. It is not authoritative, but intended to assist members in quickly understanding the requirements of FIN 48. The practice guide is available without charge to all AICPA members. For more information please visit the AICPA Web site at tax.aicpa.org/Resources/Professional+Standards+and+Ethics/Practice+Guide+on+Accounting+for+Uncertain+Tax+Positions+Under+FIN+48.htm.

Employee Benefit Plan-Related Technical Practice Aids

.74 The AICPA Staff and Employee Benefit Plan Expert Panel issued three employee-benefit-plan-related TPAs to provide guidance in implementing FASB FSP AAG INV-1 and SOP 94-4-1, *Reporting of Fully Benefit-Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans*. The TPAs are:

- TIS section 6931.08, "Types of Investments Subject to SOP 94-4, as Amended by FSP AAG INV-1 and SOP 94-4-1" (AICPA, *Technical Practice Aids*)
- TIS section 6931.09, "Financial Statement Presentation When a Plan Invests in a Common Collective Trust Fund or in a Master Trust That Holds Fully Benefit-Responsive Investment Contracts" (AICPA, *Technical Practice Aids*)
- TIS section 6931.10, "Financial Statement Disclosure Requirements When a Plan Invests in a Common Collective Trust Fund or in a Master Trust That Holds Fully Benefit-Responsive Investment Contracts" (AICPA, *Technical Practice Aids*)

.75 The TPAs address the types of investments covered by the FSP, financial statement presentation of investments in common collective trust funds and master trusts, and related disclosure requirements. The TPAs are available on the AICPA's Web site at www.aicpa.org/download/acctstd/TIS6931.08.pdf.

Recent Auditing and Attestation Pronouncements and Related Guidance

.76 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.77 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit, and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A), to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120) • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	See the "AICPA Risk Assessment Standards" section in this alert.

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Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325.01–.04), which interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.
Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330.01–.06), which interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
AICPA TPA TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.

TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This PA responds to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.
AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This PA provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditor's report.
PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This standard replaces the PCAOB's previous internal control standard, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.
PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client's audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the SEC or the PCAOB to: describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm's independence, and document the substance of the firm's discussion with the audit

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	committee. These requirements parallel the auditor's responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524. This rule is effective for audits of fiscal years ending on or after November 15, 2007.
PCAOB Conforming Amendments to the Interim Auditing Standards Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in Appendix 3 of PCAOB Release No. 2007-005A at www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.
PCAOB Report, *Report on the Second-Year Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report is based on PCAOB inspections that looked at parts of approximately 275 audits of internal control over financial reporting by registered public accounting firms. Inspections focused on four areas: integrating the audits of financial statements and internal control, using a top-down approach, using the work of others, and assessing risk.
PCAOB Report, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 300—Report on the Initial Implementation of Auditing Standard No. 2") Issue Date: January 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report focuses on aspects of the PCAOB's interim auditing standards that address the auditor's responsibility with respect to fraud, specifically AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.
PCAOB Staff Questions and Answers, *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	Topics covered include the following: • The application of Rule 3522(a) when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm • Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction

	• Whether a registered public accounting firm's independence is affected by the IRS's subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b) • Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates, and not just the audit client itself • Clarification of the term *other change in employment event* as it relates to Rule 3522(c)
PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 100—PCAOB Staff Questions and Answers") Issue Date: October 2006 (Applicable to audits conducted in accordance with PCAOB standards)	The guidance provides direction for auditing a company's estimation of the fair value of stock options granted to employees pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment*, which became applicable for financial statements of companies with fiscal years ending on or after June 15, 2006.

The Auditor's Communication With Those Charged With Governance

.78 In December 2006, the ASB issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and is effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to 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. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers, regardless of size, ownership, or organizational structure.

.79 SAS No. 114 recognizes the importance of effective two-way communication to the audit. It provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61 . However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires significant matters communicated with those charged with governance to be documented.

Identifying Those Charged With Governance

.80 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those 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.

.81 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.82 Because there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.83 In May 2006, the AICPA ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued, the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. However, with the adoption of PCAOB Auditing Standard No. 5, the PCAOB redefined these terms, which now differ from SAS No. 112.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.
- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, and identifies indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.
- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.
- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.
- Contains illustrative written communications to management and those charged with governance.

How Revisions of SAS No. 112 Affect Practice

.84 As auditors gain a better understanding of what needs to be communicated to management and those charged with governance, there may be more control deficiencies that are identified as significant deficiencies and material weaknesses, and that are then communicated to management and those charged with governance. Auditors may emphasize and therefore spend more time evaluating identified control deficiencies than in the past.

.85 Some examples of potential control deficiencies that you might find in investment companies are:

- Inadequate monitoring of the financial accounting and reporting process to detect deficiencies in the preparation of financial highlight disclosures or errors in net asset value calculations.
- Lack of management oversight or review of the preparation of financial statements, or both.
- Inadequate procedures to reconcile investment accounts to custodian records to support the existence assertion.
- Inadequate client expertise in regulatory reporting requirements resulting in the filing of erroneous information or the use of the incorrect form for regulatory filings.
- Inadequate procedures to monitor the determination of fair values of investments.
- Deficiencies in determining a registered investment company's qualification under Subchapter M of the Internal Revenue Code.

Discussions With Management and Others

.86 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. Auditors may have to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor who does not provide attest services for the client can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.87 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of *material weaknesses*. Another reason is that auditors have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in written communication as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.88 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present, because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented, detected, and corrected by the client.

Issues for Audits of Smaller Entities

.89 One issue that has arisen in audits of smaller entities is the increase in costs as a result of the time the auditor spends documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.90 Another issue that has caused concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, detecting, or correcting material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, because doing so would impair independence.[4] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.91 A weakness in monitoring ongoing activities when an auditor is performing these nonattest services may also raise independence issues. If the auditor is effectively placed in the position of monitoring the ongoing activities related to the subject matter of its own services, it might be considered to have become an element of the client's internal control structure or to have assumed responsibility for functions that are the responsibility of client management, either of which is incompatible with independence. Thus, the auditor may require the client to rectify the control weaknesses before it can provide further nonattest services.

.92 The requirements of SAS No. 112 introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing.

.93 The AICPA has published the AICPA Audit Risk Alert titled *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in implementation of this SAS. This audit risk alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; the alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

AICPA Risk Assessment Standards

.94 In March 2006, the AICPA ASB issued eight SASs referred to as the risk assessment standards (SAS Nos. 104–111). Although the SASs include many of the underlying concepts and detailed performance requirements contained in existing standards, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risks of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between the risks, controls, audit procedures, and conclusions. The risk assessment standards are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier application permitted. The following table lists the eight SASs and their effects on existing standards.

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[4] See Ethics Interpretation No. 101-3, "Performance of nonattest services," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

Statement on Auditing Standards	*Effect on Existing Standards*
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")* (AICPA, *Professional Standards*, vol. 1, AU sec. 230)	This statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230A).
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	This statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A).
SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)	This statement supersedes SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326A).
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)	This statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312A).
SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)	This statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 310), and supersedes SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A).
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314)	This statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1, AU sec. 318)	This statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)	This statement amends SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350A).

Key Provisions of the Risk Assessment Standards

.95 Whether due to error or fraud, the new risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks that may lead to a material misstatement in the client's financial statements and any mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations (COSO) of the Treadway Commission's framework at www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs will most likely result in significant changes to firm audit methodologies and the training of personnel. Therefore, it is recommended that auditors allow ample time in advance of the required implementation date. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Companion Audit Guide

.96 In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Audit Documentation Technical Practice Aids

.97 In May 2007, the ASB issued two technical questions and answers related to SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which was issued in December 2005.

.98 TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.99 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*), discusses whether the provisions of SAS No. 103 related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance*

.100 A key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms, an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.101 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date
- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.102 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf. Readers should also note the PITF is currently working on a practice alert that addresses auditing and other considerations related to electronic information that it plans to issue during the third quarter of 2007.

PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*

.103 In May 2007, the PCAOB adopted Auditing Standard No. 5, which was later approved by the SEC on July 25, 2007. This standard replaces Auditing Standard No. 2. Auditing Standard No. 5 is principles based and presents a risk-based, top-down approach designed to increase the likelihood that material weaknesses will be found before resulting in a material misstatement of a company's financial statements, while eliminating unnecessary procedures. The standard was also designed to make audits more scaleable for smaller or less complex companies. The PCAOB worked closely with the SEC to coordinate Auditing Standard No. 5 with the guidance to public company management that was approved by the SEC in May 2007. Mark Olson, PCAOB chairman, stated "The new standard is more risk-based and scalable, which will better meet the needs of investors, public companies, and auditors alike."

.104 This new standard is required for all audits of internal control for fiscal years ending on or after November 15, 2007. However, early adoption is permitted and encouraged. For more information, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk).

Recent AICPA Independence and Ethics Pronouncements

.105 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.106 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statement Nos. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB EITF Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FSPs (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA SOP 07-1 (AICPA, *Technical Practice Aids*, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*
TIS section 6140.20–.22 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss not-for-profit organizations' fund-raising expenses.
TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various employee benefit plan topics.
TIS section 6300.25–.35 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various issues related to SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts.*
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.107 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the investment companies industry were discussed in the "Accounting Issues and Developments" section of this alert. The AICPA general *Audit Risk Alert—2007/08* (product no. 022338kk) and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed in this alert. To obtain copies of AICPA literature, call (888) 777-7077 or go online at www.cpa2biz.com.

On the Horizon

.108 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to the investment companies industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.109 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. 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 in addition to those discussed here. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code +of+Professional +Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Auditing Pipeline—Nonissuers

ASB Clarity Project

.110 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB approved for exposure a discussion paper titled *Improving the Clarity of ASB Standards*. This discussion paper seeks feedback on proposed changes to the standards, including:

- Establishing objectives for each of the standards, and the auditor's obligations related to the objectives
- Structural and drafting improvements to make the standards easier to read and understand
- Inclusion, in the explanatory material of the standards, of special considerations related to audits of public entities and small entities
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards

.111 The discussion paper's comment period ended June 15, 2007. The discussion paper can be accessed at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

Convergence With International Standards

.112 The ASB has created a number of task forces charged with monitoring specific activities of the International Auditing and Assurance Standards Board (IAASB) and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of International Standards on Auditing (ISA). The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.113 In January 2006, the ASB issued a revised exposure draft of a proposed Statements on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, the ASB previously decided to defer to issuance of a final revised AT sec. 501 until the PCAOB issued its amendments and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www.aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of **Present Fairly in Conformity With Generally Accepted Accounting Principles**

.114 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards titled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA, *Professional Standards*, vol. 1, AU sec. 411]) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www.fasb.org. The ASB will issue its final SAS concurrently with the FASB's and PCAOB's issuance of their final standards.

Auditing Pipeline—Issuers

.115 Guidance issued by the PCAOB is included in the section of this alert titled "Recent Auditing and Attestation Pronouncements and Related Guidance." For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), mentioned previously.

Accounting Pipeline

.116 Presented below are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year's alert have not been finalized as of the date of this writing, and thus are included again.

Business Combinations

.117 Phase one of the business combination project resulted in the issuance of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*. In those statements, the FASB eliminated the use of the pooling of interests method of accounting for business combinations and addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. The objective of phase two of this project is to standardize business combination accounting through the convergence of the FASB and IASB accounting standards and by reconsidering the existing guidance for the purchase method of accounting for business combinations. Among the main proposals are the following:

- All acquisitions of businesses be measured at the fair value of the business acquired.
- Substantially, all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.
- Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.118 In June 2005, the FASB and IASB issued a number of exposure drafts, for which comment periods ended in October 2005. Redeliberations began in January 2006 and were completed in June 2007. The FASB and IASB expect to issue final statements during the fourth quarter of 2007. Four standards are expected to be issued:

- Proposed FASB Statement No. 141(R) and International Financial Reporting Standard No. 3(R), *Business Combinations*
- Proposed FASB Statement No. 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*
- Proposed International Accounting Standard (IAS) Statement No. 27(R)

.119 Readers should remain alert to the final issuances and visit the FASB Web site for further information.

Fair Value

.120 During phase one of the FASB's fair value option project, the FASB issued FASB Statement No. 159. In phase two of the project, the FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase two are expected to begin in the third quarter of 2007. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.121 In December 2006, the FASB issued an exposure draft titled *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure draft ended in March 2007, and the FASB has begun redeliberations to consider significant issues raised by respondents. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133, including how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entity's financial position, results of operations, and cash flows. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.122 The FASB is working on a project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, to address issues related to the permitted activities of a qualifying special-purpose entity (QSPE), isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, the FASB issued exposure draft, *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During 2007, the FASB expects to address issues related to the permitted activities of a QSPE and then issue another exposure draft during the fourth quarter of 2007 containing potential amendments to FASB Statement No. 140. See the FASB Web site for complete information.

.123 In August 2007, the FASB issued an exposure draft of FSP FAS 140-d, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions." The FSP provides implementation guidance on the circumstances that would permit a transferor and a transferee to evaluate the accounting for a transfer of a financial asset separately from a repurchase financing of that asset. The comment period for this FSP closed on September 14, 2007. See the FASB Web site for the current status of this issue.

Earnings Per Share

.124 The FASB and IASB have been working together to resolve differences between FASB Statement No. 128, *Earnings per Share*, and IAS Statement No. 33, *Earnings per Share*. This project is part of the larger FASB project, Short-term International Convergence, which has resulted in the issuance of a number of FASB Statements. Currently the FASB and IASB are addressing significant differences that remain relating to instruments that can be settled in cash or shares and are classified as a liability on an entity's balance sheet. The FASB and IASB are considering modifications to the treasury stock method and several scoping issues in which either the FASB or IASB has issued or may issue more detailed implementation guidance on earnings per share that may create a convergence difference. The FASB and IASB are expected to issue an exposure draft for public comment during the third quarter of 2007. This exposure draft will be the third exposure draft the FASB has issued on the earnings per share project. The project and current exposure draft can be reviewed on the FASB Web site.

FASB Codification and Retrieval Project

.125 The goal of this FASB project is to create a single, authoritative codification of U.S. GAAP. The codification will integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, EITF, and SEC). The codification will have a three-layered structure: topic, subtopic, and section. The FASB has structured the topics into three primary areas: overall presentation, transactional (or financial statement account), and industry. The overall presentation area addresses presentation of financial information, but does not address items such as recognition, measurement, or derecognition. The transactional or financial statement account area addresses accounting recognition, measurement, or derecognition. The industry area includes guidance unique to the industry. A codification draft is expected in 2007 and will have an extended verification period to ensure that it accurately reflects U.S. GAAP. Once the FASB addresses respondent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards. Readers can track progress of the Codification and Retrieval Project on the FASB Web site at www.fasb.org/project/codification&retrieval_project.shtml.

GAAP Hierarchy

.126 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor that is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonissuers" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.127 ***Proposed FASB EITF Issues.*** Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.128 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

.129 The following are various resources that practitioners engaged in the investment companies industry may find beneficial.

Publications

.130 Practitioners may find the following publications useful with respect to the investment companies industry:

- Audit and Accounting Guide *Investment Companies* (2007) (product no. 012627kk)
- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2007) (product no. 012517kk)
- Audit Guide *Audit Sampling* (2007) (product no. 012537kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2007) (product no. 012777kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- Audit Risk Alert *Compilation and Review Alert—2007/08* (product no. 022308kk)
- Audit Risk Alert *Independence and Ethics Alert—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Checklist Supplement and Illustrative Financial Statements for Investment Companies*(product no. 008948kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.131 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, TPAs, 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.

Continuing Professional Education

.132 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 edition) (product no. 736183kk [text] or 187191 [DVD]). 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.
- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

.133 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.134 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1- and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com.

Webcasts

.135 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high-quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.136 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.137 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.138 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.139 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. You can reach the Technical Hotline at (888) 777-7077.

Ethics Hotline

.140 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.

Industry Conference

.141 The AICPA sponsors the National Conference on the Securities Industry annually in the winter. The National Conference on the Securities Industry is a two-day conference designed to update attendees on recent developments related to the securities industry. Co-sponsored by the AICPA and the Financial Management Division of the Securities Industry & Financial Markets Association, it's the most comprehensive update in accounting, tax and regulatory matters delivered by key individuals and regulators of the SEC, NYSE, NASD, and FASB. This conference is an ideal opportunity to engage in questions and answers with leading industry experts, and offers a powerful way to network with peers, speakers and officials from government agencies. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA CAQ

.142 The CAQ (formerly the Center for Public Company Audit Firms) was created to serve investors, public company auditors and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.143 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

AICPA Industry Expert Panel—Investment Companies

.144 For information about the activities of the Investment Companies Industry Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_investco.htm.

Industry Web Sites

.145 The Internet covers a vast amount of information that may be valuable to auditors of investment companies, including current industry trends and developments. Some of the more relevant sites for auditors with investment company clients include those shown in the following table:

Organization	*Web Site*
Securities and Exchange Commission	www.sec.gov/divisions/investment
Financial Accounting Standards Board	www.fasb.org/
The Financial Industry Regulatory Authority	www.finra.org/index
Investment Company Institute	www.ici.org
Commodity Futures Trading Commission	www.cftc.org
Mutual Fund Director's Forum	www.mfdf.com
Independent Director's Council	www.idc1.org

.146 The investment company practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

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.147 This Audit Risk Alert replaces *Investment Companies Industry Developments—2006/07*.

.148 The Audit Risk Alert *Investment Companies Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's 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 appreciated. You may e-mail these comments to KBiser@aicpa.org or write to:

Kenneth R. Biser, CPA, MBA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

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Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov

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AAM Section 8110

Securities Industry Developments—2007/08

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
SECURITIES INDUSTRY DEVELOPMENTS—2007/08

This Audit Risk Alert is intended to provide auditors of financial statements of broker-dealers in securities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. Because securities broker-dealers often deal in commodity futures or function as commodity pool operators, the Audit Risk Alert expands the discussion of recent developments to include matters that may affect the audits of commodity entities as well.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

Susan M. Reed, CPA
Technical Manager
Accounting and Auditing Publications

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your securities industry audits. This alert can also be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory 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 financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The securities industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic, and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the entity's financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, GDP increased at an annual rate of 2.9 percent in 2006, consistent with the pace of growth experienced in 2005 when GDP increased by 3.1 percent. During the first quarter of 2007, GDP increased by an annual rate of only 0.6 percent. However, according to second quarter preliminary estimates, GDP increased at an annual rate of 4.0 percent.

.11 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, with an annual average rate of 4.6 percent representing approximately 7 million people. The 2006 rates represent the lowest annual rate and total number of jobless since 2000, according to the U.S. Department of Labor, Bureau of Labor Statistics. During the first half of 2007, the unemployment rate averaged 4.5 percent. These data further demonstrate the economic growth the United States has experienced since the beginning of 2006.

.12 After a period of rising rates during the first half of 2006, the Federal Reserve kept its target for the federal funds rate at 5.25 percent for 10 consecutive meetings (June 2006–August 2007). At that time, the Federal Reserve indicated future federal funds rate adjustments would likely depend upon the outlook for economic growth and inflation. Since its August 2007 meeting, and in response to shaky financial market conditions, the Federal Reserve has taken several action steps. It announced that it would provide reserves as necessary through the open market to facilitate the orderly functioning of financial markets by promoting trading in the federal funds market at rates close to the 5.25 percent target rate. On August 17, 2007, it announced that financial market conditions had deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth. Then, at its September meeting, the Federal Reserve decided to lower its target for the federal funds rate by 50 basis points to 4.75 percent, citing increased uncertainty surrounding the economic outlook. The Federal Reserve also decided to decrease the discount rate by 50 basis points to 5.25 percent, to consistently keep the spread between the primary credit rate and the target federal funds rate at 50 basis points. Auditors should remain alert to developments in the financial markets and how they may affect your audit engagements.

.13 Although 2007 to date (up through early October) has been a year of records for the stock market, it is also a year that has seen the mortgage markets begin to unravel. Subprime mortgages have been blamed as one of the sources of the credit market problems, and the resultant illiquid (or less liquid) credit market conditions. And as the housing market weakens, it remains to be seen what effect this has on the stock market and the economy in general. The consensus at the time of this writing is that economic growth in the near future will slow down due to the increase in the cost of credit.

Industry Trends and Conditions

The Securities Industry

.14 The year 2006 was a record year for the U.S. securities industry. Pretax profits reached $33.1 billion for 2006. That is 88.2 percent above the $17.6 billion pretax profit that was earned in 2005 and 4.7 percent above the previous record of $31.6 billion pretax profit set in 2000. In the first quarter of 2007, the industry reported pretax profits of $7.7 billion. This 2007 first quarter figure was down 28.7 percent from the immediately preceding quarter and 1.6 percent below the same period in the preceding year. Despite the decrease, first quarter 2007 profits were the third best first quarter results on record.

.15 The markets this year have hit record high levels with significant declines in between. The Dow Jones Industrial Average (DJIA or Dow), NASDAQ Stock Market, Inc. (NASDAQ), and the Standard & Poor's 500 Index (S&P 500) rose from the beginning of the year, but hit significant lows in March and August of 2007. Despite the declines, all three markets hit record highs in July and again on October 1, 2007 (the last date considered at the time of this writing).

.16 The Dow started the year at 12,459.54. At the end of the second quarter of 2007, it was up 20.3 percent from a year earlier. The third quarter of 2007 has been a tumultuous period. In July 2007, the Dow closed above 14,000 for the first time ever, closing at 14,000.41 on July 19, 2007. It should be noted that it took only 59 days to go from the previous record of 13,000 to 14,000. Then, in August, the Dow dropped below 13,000 again—closing at 12,861.47 on August 15, 2007 (taking less than a month to decrease 1,000 points). By October 2007, the Dow again closed above 14,000—closing at 14,087.55 on October 1, 2007 (the last day considered at the time of this writing).

.17 The NASDAQ opened 2007 at 2,445.07. Its path during 2007 has been similar to the Dow in that it hit a high close of 2,720.04 on July 19, 2007, and then hit another high close of 2,740.99 on October 1, 2007. It also experienced a couple of large declines, closing at 2,340.6799 on March 5, 2007, and 2,451.07 on August 16, 2007.

.18 The S&P 500 closed above 1,400 for the first time in 6 years on November 17, 2006. After rising for several months, it fell below 1,400 again on March 5, 2007—closing at 1,374.12. After a volatile period, it closed above the 1,500 mark, closing at 1,547.04 on October 1, 2007.

.19 How 2007 will finish is as uncertain as the economy is currently. For more information on the markets, please refer to the Securities Industry and Financial Markets Association (SIFMA) Research Reports, which can be accessed at www.sifma.org/research/research_reports.html.

The Commodities Industry

.20 Global futures and options contract volume has continued to increase through 2006 and into 2007. In the first 8 months of 2007, volume on U.S. futures exchanges reached 4 billion contracts, a 33 percent increase from the same period in 2006. The volume of contracts traded on foreign exchanges increased 23 percent compared to the first 8 months of 2006. Trading volume in interest rate and equity products continued to account for more than half of worldwide trading volume.

.21 The growth in futures volume and markets is further reflected in increased customer funds held by entities registered with the Commodity Futures Trading Commission (CFTC) as futures commission merchants (FCMs) for trading on U.S. and foreign futures and options exchanges. The total amounts required under CFTC regulations to be held in segregated or secured accounts on behalf of FCM customers increased by $9 billion from approximately $139 billion as of August 31, 2006, to approximately $148 billion as of August 31, 2007.

.22 The U.S. futures industry, in addition to the increasing volume and customer participation, also has experienced other significant changes through 2006 and into 2007. In 2007, the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT), the two largest contract markets designated by the CFTC, completed their merger. The new CME/CBOT combined organization, U.S.-based CME Group, Inc., is devoted to derivatives trading and clearing. Also, in 2007, InterContinental Exchange (ICE) acquired the New York Board of Trade (NYBOT) (now known as ICE Futures U.S.), and the Winnipeg Commodities Exchange.

Legislative and Regulatory Developments[1]

.23 Chapter 5, "Auditing Considerations," of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (the Broker-Dealer Guide), discusses auditing considerations for an audit of the financial statements of a broker-dealer. The Broker-Dealer 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 would not otherwise choose to do so.

.24 The audit and reporting requirements for securities broker-dealers are regulated by Rule 17a-5 under the Securities Exchange Act of 1934 (the Exchange Act). Qualifications and reports of independent accountants of FCMs and introducing brokers (IBs) are specified by Regulation 1.16 of the Commodity Exchange Act (CEA). Alternative regulatory frameworks have been created for consolidated supervised entities and over-the-counter derivatives dealers. Further, 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.

.25 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.

.26 Certain regulatory activities and developments relevant to entities operating in the securities industry are presented in the following section. Presented first are developments arranged by subject, followed by developments by regulatory authority. Included are summaries of some rules the Securities and Exchange Commission (SEC), CFTC, and Self-Regulatory Organizations (SROs) have issued since the writing of last year's alert. In addition to reading the following regulatory matters, see the AICPA *Audit Risk Alert—2007/08*, the Audit Risk Alert *Independence and Ethics—2007/08*, and the Audit Risk Alert *SEC and PCAOB Alert—2007/08* for a discussion of current issues.

NASD and NYSE Regulation Combine Operations

.27 In November 2006, it was announced that the National Association of Securities Dealers (NASD) and the member regulation, enforcement, and arbitration operations of the New York Stock Exchange (NYSE or the Exchange) planned to combine operations. This consolidation occurred and created the largest nongovernmental regulatory organization for brokers and dealers of securities in the United States. The new organization has been named the Financial Industry Regulatory Authority (FINRA).

.28 The consolidation was approved by the SEC on July 26, 2007, and became effective July 30, 2007. According to the FINRA news release announcing the consolidation, the organization will conduct the regulatory oversight of 5,000 securities firms and 666,000 registered representatives. The organization will be responsible for rule writing, firm examination, enforcement and arbitration, and mediation functions, along with all functions that were previously overseen solely by NASD. This includes market regulation under contract for NASDAQ, the American Stock Exchange, the International Securities Exchange, and the Chicago Climate Exchange.

.29 The new organization, FINRA, emphasized that investor protection and market integrity are primary objectives. The organization will be investor-focused and more streamlined so that it will be better suited to

[1] Readers should be alert for updates, amendments, or other changes to the rules discussed in this section and for other recent developments related to regulatory activities. The brief summaries provided in this section of the alert are for informational purposes. Readers should refer to the full text of the regulations. In addition, not all regulatory activity is included in this publication. The complete text of Securities and Exchange Commission (SEC) rules, including those rules adopted subsequent to the publication of this alert, can be obtained from the SEC Web site at www.sec.gov; Commodity Futures Trading Commission (CFTC) rules at www.cftc.gov; Financial Industry Regulatory Authority (FINRA) rules at www.finra.org; and National Futures Association (NFA) rules at www.nfa.futures.org. See the "Industry Web Sites" table at the end of this alert for a list of Internet sources.

the complexity and competitiveness of today's global capital markets. Furthermore, FINRA asserted that by eliminating overlapping regulation, establishing a uniform set of rules, and having oversight responsibility in a single organization, investor protection will be enhanced while increasing the competitiveness of the financial markets. For more information on FINRA, visit www.finra.org.

Portfolio Margin Expanded Pilot Program Extended

.30 NYSE Rule 431, *Margin Requirements*, generally prescribes minimum initial and maintenance margin requirements. On July 14, 2005, the SEC approved, on a pilot basis expiring July 31, 2007, amendments to Rule 431 to permit the application of a risk-based margin requirement (portfolio margining) to certain eligible products (including listed broad-based securities index options, warrants, futures, futures options, and related exchange traded funds) as an alternative to strategy-based margin requirements. Amendments to Rule 726, *Delivery of Options Disclosure Document and Prospectus*, were also approved, requiring disclosure to and written acknowledgment from customers in connection with the use of portfolio margining. For more information, please refer to SEC Release No. 34-52031 and NYSE Information Memo No. 05-56. By separate orders, the SEC also approved a parallel rule filing by the Chicago Board Options Exchange (CBOE), and a related rule filing by the Options Clearing Corporation. See SEC Releases No. 34-52032 and No. 34-52030.

.31 On July 11, 2006, the SEC approved additional amendments to Rule 431 that:

1. Expanded the scope of products eligible for portfolio margining and cross-margining;
2. Conformed customer disclosure requirements under Rule 726 to comply with this expansion; and
3. Modified certain net capital requirements in connection with the maintenance of portfolio margin accounts.

.32 Collectively, these amendments are referred to as the Expanded Pilot. The Expanded Pilot broadened the scope of products eligible for portfolio margining and cross-margining to include listed security futures and listed single stock options. Further, the Expanded Pilot permitted customers of pilot participants to effect transactions solely in security futures and listed single stock options without maintaining the $5 million equity requirement applicable to effecting transactions in all other eligible products. See SEC Release No. 34-54125 and NYSE Information Memo No. 06-57 for more information.

.33 On December 12, 2006, the SEC approved additional amendments to NYSE Rule 431, which permit the application of portfolio margining to an expanded universe of eligible products. In addition, amendments to NYSE Rule 726 eliminate the sample portfolio margining risk disclosure statement from the rule. However, the rule will continue to require member organizations to provide customers with a written disclosure statement in a form prescribed by the NYSE, as well as to receive from customers a signed acknowledgement (see Information Memo 07-27, *Sample Portfolio Margining Risk Disclosure and Acknowledgment Statements*, issued 03/17/2007). The amendments are effective April 2, 2007. See SEC Release No. 34-54918 and NYSE Information Memo No. 06-86 for more information.

.34 Also, on December 12, 2006, the SEC approved a rule change proposed by the CBOE, as amended, to broaden its Rule 12.4, *Portfolio Margin and Cross-Margin for Index Options*, to expand the scope of products that are eligible for treatment as part of CBOE's approved portfolio margin pilot program and to eliminate the requirement for a separate cross-margin account. The scope of eligible products in the pilot is expanded to include margin equity securities, unlisted derivatives, listed options, and securities futures. See SEC Release No. 34-54919 for more information.

.35 On March 14, 2007, the SEC approved a Portfolio Margin Pilot Program for the NASD in SEC release 34-55471. The portfolio margin pilot program is substantially similar to margin rule amendments by the NYSE and CBOE. NASD provided the required disclosures and written acknowledgements in NASD Notice to Members 07-14 released in March 2007.

.36 On July 19, 2007, the SEC release 34-56107 extended the existing NYSE expanded pilot program until July 31, 2008. The CBOE expanded pilot program (SEC Release 34-56109) and the NASD Portfolio Margin Pilot Program (SEC Release 34-56108) were also extended to July 31, 2008.

.37 Portfolio margining is a margin methodology that sets margin requirements for an account based on the greatest projected net loss of all positions in a "security class" or "product group" as determined by a theoretical pricing model using multiple pricing scenarios. The goal of portfolio margining is to set levels of margin that more precisely reflect actual net risk. The eligible participant benefits from portfolio margining in that margin requirements calculated on net risk are generally lower than those that apply to specific positions or strategies. Accordingly, customers eligible to use portfolio margining will gain additional leverage. Broker-dealers will benefit from portfolio margining because it permits them to offer a more competitive financing to customers seeking to implement sophisticated equity trading strategies. As a trade-off, broker-dealers will be required to expend additional efforts to manage the higher credit and market exposures emanating from portfolio margining activities.

.38 As specified in NYSE Information Memo 06-86, member organizations, for which the NYSE is the Designated Examining Authority (DEA), seeking to participate in portfolio margining must provide written notification and receive approval from the NYSE prior to establishing a portfolio margining methodology. In this regard, member organizations are expected to establish written procedures for monitoring the risk associated with portfolio margin accounts; such procedures must incorporate a methodology for assessing any potential risk to the member organization's capital. Readers should refer to NYSE Information Memo 06-57, which contains the procedures that must be fully documented.

Anti-Money Laundering Update

.39 The SEC has added the Anti-Money Laundering (AML) Source Tool on its Web site to assist broker-dealers in complying with applicable laws and regulations. The tool is a compilation of key AML laws, rules, and guidance that assist broker-dealers in meeting their obligations. In addition, it contains a list of useful telephone numbers and Web sites. To access the AML Source Tool, go to www.sec.gov/about/offices/ocie/amlsourcetool.htm.

.40 On a related note, the Financial Crimes Enforcement Network (FinCEN) has delayed the implementation of a revised Suspicious Activity Report (SAR). The form was originally scheduled to become effective on June 30, 2007, and become mandatory on December 31, 2007. FinCEN will establish new effective and mandatory compliance dates for using the revised SAR form in a future notice. FinCEN has also issued guidance "Suspicious Activity Report Supporting Documentation" (FIN-2007-G003) that clarifies items related to supporting documentation required under SAR regulations. This guidance can be accessed at the SEC AML Web site at the address listed previously.

Proposed Amendments to Financial Responsibility Rules for Broker-Dealers

.41 The SEC has proposed amendments to its customer protection, books and records, notification, and net capital rules for broker-dealers under the Exchange Act. In March 2007, the SEC released "Amendments to Financial Responsibility Rules for Broker-Dealers." The proposed rule changes address several areas of emerging concern regarding financial requirements for broker-dealers, including updating the financial responsibility rules and making certain technical amendments. The following explanations are intended to briefly summarize the proposed amendments, which in some cases are very technical. Please refer to SEC Release 34-55431 for a complete description of these amendments. The release can be accessed at www.sec.gov/rules/proposed/2007/34-55431.pdf.

Proprietary Accounts of Broker-Dealers

.42 This proposed amendment would require broker-dealers to treat accounts they carry for domestic and foreign broker-dealers in the same manner as customer accounts for purposes of the reserve formula of

Rule 15c3-3. Because broker-dealers are not considered to be *customers* as defined in Rule 15c3-3, this amendment would require a separate reserve computation for proprietary accounts of other domestic and foreign broker-dealers in addition to the reserve computation currently required for customers. Also, a separate reserve account for the benefit of the domestic and foreign broker-dealers must be established by the carrying firm. See section II.A.1 of the release for details.

Banks Where Special Reserve Deposits May Be Held

.43 The proposed amendment would not allow cash deposits to be held at affiliate banks for the purpose of meeting reserve requirements with respect to customers or other broker-dealers. In addition, the proposal contains limits on the amount of cash reserves that may be maintained at any one nonaffiliated bank. The limitations would prevent a broker-dealer from maintaining a reserve deposit in the form of cash at a single unaffiliated bank that exceeds a percentage of the broker-dealer's or the bank's capital. The exclusion and limitation does not apply to deposits of securities. See section II.A.2 of the release for details.

Expansion of the Definition of Qualified Securities to Include Certain Money Market Funds

.44 Under the proposed amendment, certain money market funds (those that only invest in securities meeting the definition of *qualified security* in Rule 15c3-3) that also meet several other requirements may be used to replace cash held in the customer reserve account. This should decrease the burdens on those broker-dealers that would be impacted by the proposed amendment related to customer reserve account cash deposits into affiliate and nonaffiliate banks, as discussed previously.

Allocation of Customers' Fully Paid and Excess Margin Securities to Short Positions

.45 The proposed amendment would require a broker-dealer to take prompt steps to obtain physical possession or control over securities of the same issue and class as those included on the broker-dealer's books as a proprietary short position or as a short position for another person. The result will be that the broker-dealer will no longer be able to monetize the value of the security and use the cash for proprietary activities. The action would be required when the short position has aged more than 10 business days (or more than 30 calendar days, if the broker or dealer is a market maker in the securities).

Treatment of Free Credit Balances

.46 The proposed amendment would make it unlawful for a broker-dealer to convert, invest, or otherwise transfer free credit balances unless the broker-dealer has obtained a specific order, authorization, or draft from the customer and only under the terms and conditions specified by the customer. With respect to situations where a broker-dealer is recommending a sweep of free credit balances to either a money market fund or a bank deposit account, the broker-dealer would need to first obtain a customer's permission to initiate or change a sweep option to or from a money market fund or a bank deposit account. Second, the broker-dealer would need to provide the customer with all notices and disclosures required by the self-regulatory organizations, which the broker-dealer is a member of, regarding the selected investment option and the deposit of free credit balances. Third, the broker-dealer would need to provide the customer with notice in the customer's quarterly statement that the money market fund or bank deposit account can be liquidated on the customer's demand and converted back into a free credit balance held in the customer's securities account. Fourth, the broker-dealer would need to provide the customer with notice of at least 30 calendar days before changing the product (for example, from one money market fund to another), the product type (for example, from a money market fund to a bank account), or the terms and conditions under which free credit balances are swept.

Importation of Rule 15c3-2 into Rule 15c3-3

.47 Due to the fact that the majority of Rule 15c3-2 is obsolete, the relevant portion would be merged into Rule 15c3-3, and the former Rule 15c3-2 would be deleted. Under this proposal, the requirement that the clearing firm inform customers of the amounts due to them and that such amounts are payable on demand would be added to Rule 15c3-3.

Aggregate Debit Items Charge

.48 According to the proposed amendment, if a broker-dealer computes its net capital pursuant to the "alternative method," the broker-dealer is currently required to reduce its total debits by three percent of debit balances in customer cash and margin accounts when computing its reserve requirement. The SEC proposes to change the required reduction from three percent to one percent of debit balances in customer cash and margin accounts for broker-dealers using the *alternative method*.

Proprietary Accounts Under the Commodity Exchange Act

.49 An amendment to Rule 15c3-3 would clarify that funds held in a commodity account meeting the definition of a *proprietary account* under CEA regulations are not to be included as *free credit balances* in the customer reserve formula.

Holding Futures Positions in a Securities Portfolio Margin Account

.50 The CBOE, the NYSE, and (more recently) the NASD have amended their margin rules to permit broker-dealer members to compute customer margin requirements using a portfolio margining methodology. Under these rules, a broker-dealer can combine securities and futures positions into the portfolio margin account. The SEC proposes to amend Rule 15c3-3 to provide Securities Investor Protection Act (SIPA) protection to futures-related cash and options on futures in a portfolio margin account. This is done mainly by amending the definition of "free credit balance" in Rule 15c3-3 to include the market value of the options on futures so that it is included in SIPA liquidation.

Documentation of Risk Management Procedures

.51 Under the proposed amendment, broker-dealers that have more than (1) $1 million in aggregate credit items as computed under the customer reserve formula, or (2) $20 million in total capital including subordinated debt would be required to make and keep current records documenting their implemented systems of internal risk management control. The proposal also would require the broker-dealer to maintain these records for three years after the date the broker-dealer ceases to use the system of controls. It is noted that the proposed changes do not require any minimum elements that would be required to be included in a firm's internal controls, or any particular issues that need to be addressed. Instead, the amendment is designed to ensure that broker-dealers clearly identify the procedures (if any) they use to manage the risks in their business.

Amendments With Respect to Securities Lending and Borrowing and Repurchase/Reverse Repurchase Transactions

.52 The SEC is proposing two amendments designed to improve the regulatory oversight of securities lending and repurchase (repo) transactions. The first would clarify that a broker-dealer providing securities lending and borrowing services is assumed to be acting as a principal and is, therefore, subject to the applicable capital deductions. The only way a broker-dealer can be considered an agent (and not a principal) is if certain steps are taken to disclaim principal liability. The broker-dealer must disclose the identities of the borrower and the lender to each other and obtain written agreements from each stating that the broker-dealer is acting as agent and, therefore, assumes no principal liability in connection with the transaction.

.53 The second proposal would require broker-dealers to notify regulators whenever the amount of money payable against all securities loaned or subject to a repurchase agreement, or the total contract value of all securities borrowed or subject to a reverse repurchase agreement, exceeds 25 times tentative net capital.

For purposes of this calculation, transactions involving government securities (as defined in Section 3(a)(42) of the Exchange Act) are excluded. This would allow regulators to be able to respond more quickly in the event a firm is approaching insolvency.

Requirement to Subtract From Net Worth Certain Liabilities or Expenses Assumed by Third Parties and Nonpermanent Capital Contributions

.54 Under this proposed amendment, in computing net capital, a broker-dealer would be required to reduce net worth by the full amount of any liabilities related to its activities that have been assumed by a third party, if the broker-dealer cannot demonstrate that the third party has the resources independent of the broker-dealer's income and assets to pay such liabilities. Items that would evidence the third party's financial capacity are current audited financial statements, tax returns, or regulatory filings containing financial reports.

.55 In addition, capital that is contributed under an agreement giving an investor the opportunity to withdraw the contribution, or capital that is intended to be withdrawn within one year, would have to be recognized by the broker-dealer as a liability.

Requirement to Deduct the Amount a Fidelity Bond Deductible Exceeds Self-Regulatory Organizations Limits

.56 According to the proposed amendment, a broker-dealer must deduct, with regard to fidelity bonding requirements prescribed by a broker-dealer's examining authority, the excess of any deductible amount over the maximum deductible amount permitted by that authority.

Broker-Dealer Solvency Requirement

.57 Under the proposed amendment, a broker-dealer would be required to cease its securities business activities if it is insolvent. *Insolvent* would be defined as, among other things, a broker-dealer's placement in a voluntary or involuntary bankruptcy or similar proceeding; the appointment of a trustee, receiver, or similar official; a general assignment by the broker-dealer for the benefit of its creditors; an admission of insolvency; or the inability to make computations necessary to establish compliance with the Net Capital Rule. In addition, a proposed amendment would require a broker-dealer meeting the definition of *insolvent* to provide immediate notice to the SEC, the broker-dealer's DEA and, if applicable, the CFTC.

Amendment to Rule Governing Orders Restricting Withdrawal of Capital From a Broker-Dealer

.58 Currently Rule 15c3-1(e) provides that broker-dealers must notify the SEC upon certain withdrawals of capital. The SEC may also issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to certain parties under certain circumstances. One of the circumstances is when withdrawals, advances, or loans (when aggregated with all other withdrawals, advances, or loans on a net basis during a 30 calendar-day period) exceed 30 percent of the firm's excess net capital. Due to the difficulty of calculating whether the 30 percent of excess net capital threshold has been met, the SEC proposes to remove the 30 percent of excess net capital limitation. All other conditions in Rule 15c3-1(e) would remain unchanged.

Amendment to Appendix A of Rule 15c3-1

.59 The SEC previously adopted a temporary amendment which permits broker-dealers to employ theoretical option pricing models to calculate haircuts for listed options and related hedge positions. The SEC now proposes to make this temporary amendment permanent.

Money Market Funds

.60 The haircut of 2 percent that broker-dealers must apply under Rule 15c3-1 for money market funds would be reduced to 1 percent under the SEC proposal.

Technical Amendments to the Financial Responsibility Rules

.61 A number of technical amendments are proposed to remove superfluous or redundant text.

Regulatory Update—SEC

.62 In addition to reading the following SEC regulatory matters, readers should also visit the SEC Web site at www.sec.gov to keep informed about recent SEC rulemaking activities and for further information.

Final Rules to Implement the Bank Broker Provisions of the Gramm-Leach-Bliley Act (SEC Releases 34-56501 and 34-56502)

.63 The SEC and the Board of Governors of the Federal Reserve System announced the adoption of final joint rules to implement the bank broker provisions (and related rules and rule amendments) of the Gramm-Leach-Bliley (GLB) Act. This will essentially allow customers to obtain a wide variety of financial products through their bank. The rules define the scope of securities activities that a bank may conduct without registering with the SEC as a securities broker and implement the most important *broker* exceptions for banks adopted by the GLB Act. The rules implement the statutory exceptions that allow a bank (subject to certain conditions) to continue to conduct securities transactions for its customers as part of the bank's functions and to refer customers to a securities broker-dealer pursuant to a networking arrangement with the broker-dealer. These rules are designed to accommodate the business practices of banks and to protect investors. Banks are exempt from complying with the rules until the first day of their first fiscal year that commences after September 30, 2008.

Adoption of Updated EDGAR Filer Manual (SEC Release 33-8834—see release for list of other applicable releases)

.64 The Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) Filer Manual was updated to incorporate a number of changes in the rules and in the function of the system. Effective date is August 20, 2007.

Regulation SHO and Rule 10a-1 and amendments (SEC Releases 34-55970 and 34-56212)

.65 The SEC amended the short sale price test under the Exchange Act to remove restrictions on the execution prices of short sales (price tests) and prohibit any SRO from having a price test. Regulation SHO was also amended to remove the requirement that a broker-dealer mark a sell order of an equity security as *short exempt* if the seller is relying on an exception from a price test. The second amendment eliminates the grandfather provision of Regulation SHO, amends the close-out requirement of Regulation SHO for certain securities that a seller is *deemed to own*, and updates the market decline limitation referenced in the regulation. Effective dates are July 3, 2007, and October 15, 2007.

Technical Amendments to Form BD and Form BDW (SEC Release 34-55643)

.66 The uniform broker-dealer registration form and the uniform request for withdrawal from broker-dealer registration have been updated. Effective date is April 23, 2007.

Revisions to Non-Public Broker-Dealer Financial Statement Requirements (SEC Release 34-54920)

.67 Broker-dealers who are not issuers may file with the SEC a balance sheet and income statement and may send to their customers a balance sheet certified by an independent public accountant instead of by a Public Company Accounting Oversight Board (PCAOB) registered public accounting firm for fiscal years ending before January 1, 2009. A 2005 extension was set to expire on January 1, 2007, but was extended for 2 additional years.

Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities

.68 The Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the SEC have issued a statement related to complex structured finance transactions (CSFT). The use of this type of product is considered to be an essential part of capital markets, and there is a broad array of products with varying levels of complexity. Therefore the agencies have issued this statement to describe the types of risk management principles that they believe may help a financial institution to identify CSFTs that may pose heightened legal or other risks to the institution and to evaluate, manage, and address those risks within the entity's internal control framework. A copy of this interagency statement can be found online at www.sec.gov/rules/policy/2007/34-55043.pdf.

Internal Control Over Financial Reporting Developments

.69 The SEC has finalized several rules related to its required report on internal control over financial reporting. More information regarding SEC developments can be found in the *SEC and PCAOB Alert—2007/08* (product no. 022498kk). See also the SEC Web site at www.sec.gov for complete information.

Definition of a Significant Deficiency

.70 On August 3, 2007, the SEC posted a final rule whereby it defined the term *significant deficiency* for purpose of implementing Section 302 and Section 404 of the Sarbanes-Oxley Act of 2002. The term is defined as "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting." The full text of this rule can be found online at www.sec.gov/rules/final/2007/33-8829.pdf. This definition of significant deficiency applies to issuers and auditors of issuers. Auditors of nonissuers must use the SAS No. 112 definition in AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1).

Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934

.71 The SEC posted Interpretive Release No. 33-8810 and No. 34-55929 on June 20, 2007, to provide guidance for management regarding its evaluation and assessment of internal control over financial reporting. This guidance is organized around two broad principles. The first principle is that management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner. The guidance describes a top-down, risk-based approach to this principle. The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. The guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation. More specifically, this interpretive guidance:

- Explains how to vary evaluation approaches for gathering evidence based on risk assessments.
- Explains the use of "daily interaction," self-assessment, and other ongoing monitoring activities as evidence in the evaluation.

- Explains the purpose of documentation and how management has flexibility in documenting support for its assessment.
- Provides management significant flexibility in making judgments regarding what constitutes adequate evidence in low-risk areas.
- Allows for management and the auditor to have different testing approaches.

.72 The text of the full interpretation can be found online at www.sec.gov/rules/interp/2007/33-8810.pdf.

Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting

.73 On June 20, 2007, the SEC posted an amendment to its rules to clarify several issues related to management's Report on Internal Control over Financial Reporting. One clarification is that an evaluation of internal control over financial reporting that complies with the SEC's interpretive guidance published in Release No. 34-55929 is one way to satisfy the requirement for management to evaluate the effectiveness of the issuer's internal control over financial reporting. However, the use of this guidance is voluntary. The SEC has also amended its rules to define the term *material weakness* as "a deficiency or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis." Lastly, the SEC clarified that an auditor is required to express a single opinion directly on the effectiveness of internal control over financial reporting in its attestation report on internal control over financial reporting (the auditor does not have to report on management's assessment of internal control over financial reporting). The amendments are intended to facilitate more effective and efficient evaluations of internal control over financial reporting by management and auditors. Access www.sec.gov/rules/final/2007/33-8809.pdf for the entire release.

Regulatory Update—CFTC

.74 The following summarizes certain amendments to regulations and interpretations of the CFTC and other regulatory guidance issued or that became effective in the latter part of 2006 and in 2007. The amendments affected the financial reporting requirements of registered FCMs, and also of IBs that are not guaranteed by FCMs. The amendments were published in the Federal Register, and they and the other items discussed in the following paragraphs can be accessed electronically at the CFTC Web site at www.cftc.gov.

Amendment to Regulation 3.10 to Require Certain Registrants to Conduct Annual Review of Registration Information

.75 Effective August 1, 2007, the CFTC amended Regulation 3.10 to require each registered FCM, IB, commodity trading advisor, commodity pool operator (CPO), and leverage transaction merchant to conduct an online annual review of the firm's registration information maintained by the National Futures Association (NFA). The amendment is intended to enhance the accuracy of the registration information maintained in the NFA's registration database. The CFTC also adopted a technical and conforming amendment to CFTC Regulation 3.33(f).

CFTC Staff and FinCEN Issue Guidance on Application of CIP Rules to Give-Up Arrangements

.76 In April 2007, the staffs of the CFTC and the FinCEN jointly issued guidance on the application of the customer identification program (CIP) regulation to give-up arrangements in the futures industry. The guidance is in response to a request from the Futures Industry Association, a futures industry trade association, about whether FCMs acting solely as executing brokers in give-up arrangements are required to comply with CIP requirements.

.77 The guidance clarifies the CIP regulation for FCMs that was issued in 2003 by stating that clearing brokers in give-up arrangements are required to comply with CIP requirements because they establish a formal relationship with a futures and options customer when they open an account. The guidance explains that, subject to a limited exception, executing brokers, who in a give-up arrangement facilitate trades, do not establish a formal relationship requiring them to apply their CIPs to such futures and options customers.

.78 The guidance also reminds FCMs that they must have an AML program that contains risk-based policies, procedures, and controls for assessing money laundering risk posed by all of its operations, including its execution brokerage activities; for monitoring and mitigating that risk; and for detecting and reporting suspicious activity.

CFTC Adopts Rule Requiring FCMs to Become Members of a Registered Futures Association

.79 Effective February 21, 2007, the CFTC adopted an amendment to Regulation 170.15(a) that requires a person that is registered as an FCM, regardless of whether he or she is required to be so registered, to become members of a registered futures association (RFA). The action will further the goals of industry self-regulation and CFTC oversight, a cornerstone of the Commodity Futures Modernization Act of 2000, by ensuring that an RFA, and not the CFTC, will be responsible for monitoring the activities of FCMs in the first instance.

Regulatory Update—Self-Regulatory Organizations

.80 Under the Exchange Act, all broker-dealers are required to be members of an SRO such as FINRA, or some other organization that is designated to perform routine surveillance and monitoring of its members. Likewise, CFTC regulations require FCMs to designate a self-regulatory organization (DSRO). During the past year, a number of significant regulations were issued by SROs and DSROs, some of which are described in the following sections. Please refer to the Web sites of the respective SROs and DSROs for a complete listing of recently issued rules and regulations.

.81 On July 31, 2007, the consolidation of the NASD and the member regulation, enforcement, and arbitration operations of the NYSE became effective. The consolidated entity has been named the FINRA. Please see the section titled "NASD and NYSE Regulation Combine Operations" earlier in this alert for more information. To date, the rules of these two organizations have not yet been merged together. Therefore, we will list new regulatory developments separately for the NASD and the NYSE in this year's alert.

NASD Rulemaking

Notice to Members 06-23—NASD Reminds FINOPs of their Obligations under NASD Rule 1022 and Issues Guidance to FINOPS Who Work Part-Time, Work Off-Site, or Hold Multiple Registrations

.82 NASD issued this notice to members to remind member firms and registered financial and operations principals (FINOPs) of a FINOP's duties and responsibilities under Rule 1022 (Categories of Principal Registration). These duties are applicable to all FINOPs, regardless of whether they are employed full-time or part-time, perform such duties on-site or off-site of the member firm, or hold registrations with more than one firm. This notice also provides additional guidance to assist FINOPs who are employed part-time, operate off-site, or hold multiple registrations in fulfilling their duties. Additionally, NASD reminds members and FINOPs that their failure to meet their responsibilities can result in disciplinary actions against both the FINOP and the member firm employing the FINOP.

Notice to Members 06-48—SEC approves Amendments to NASD Rules 2210 and 2211 to Require Disclosure of Fees and Expenses in Mutual Fund Performance Sales Material; Effective Date: April 1, 2007

.83 This notice sets forth the disclosure and presentation requirements on certain member communications with the public that presents non–money market mutual fund performance data. Such communication must disclose the standardized performance information mandated by Rule 482 under the Securities Act of 1933 and, to the extent applicable, the fund's maximum front-end or back-end sales charge and annual operating expense ratio. The rule states that the required information is to be presented prominently, and in any print advertisement, in a prominent text box.

Notice to Members 07-16—Frequently Asked NASD Financial and Operational Questions

.84 This notice provides member firms with answers to many frequently asked questions.

Notice to Members 07-32—NASD Amends Rule 3013 and Interpretive Material 3013 to Permit Members to Designate Co-Chief Executive Officers and Multiple Chief Compliance Officers

.85 Beginning July 16, 2007, the compliance date, NASD member firms may designate co-chief executive officers and multiple chief compliance officers to discharge the requirements of Rule 3013 (Annual Certification of Compliance and Supervisory Processes).

Notice to Members 07-45—Amendments to NASD Rule 3210 to Conform with Amendments to the SEC's Regulation SHO Delivery Requirements

.86 Beginning on the effective date, October 15, 2007, firms are required to close out within 35 consecutive settlement days any previously "grand-fathered" fail-to-deliver positions in a nonreporting threshold that is on the Rule 3210 threshold list on that date. New fails in a nonreporting threshold security after October 15, 2007, will be subject to a 13 consecutive settlement day close-out requirement. Please see the notice for information regarding an exception to this rule for closing out fails to deliver resulting from sales of nonreporting threshold securities pursuant to SEC Rule 144. The rules are available at the Rules and Regulations tab at the FINRA Web site at www.finra.org.

NYSE Rulemaking

Information Memo 06-80, Permitting DVP/RVP Customers to Opt Out of Receiving Statements, Issued November 30, 2006

.87 The SEC has approved amendments to NYSE Rule 409, "Statements of Accounts to Customers," permitting institutional customers doing business solely on a deliver versus payment/receive versus payment basis (DVP/RVP) to opt out of receiving statements as otherwise required by the rule, subject to prescribed requirements.

Information Memo 06-87, SIPC Information for Customers, Issued December 22, 2006

.88 The SEC has approved amendments to NYSE Rule 409, "Statements of Accounts to Customers" requiring member organizations to add a legend to customer statements of account advising customers to report promptly any inaccuracy or discrepancy in that person's account to his or her brokerage firm, and a new Rule 409A requiring that member organizations advise customers, in writing, of the availability of information regarding the Securities Investor Protection Corporation (SIPC). The SEC recently approved comparable amendments to NASD Rule 2340, "Customer Account Statements."

Information Memo 07-37, Amendments to NYSE Net Capital Rules, Issued April 25, 2007

.89 The SEC approved amendments to NYSE Rules 325 and Rule 326 to reflect CFTC amendments under the Exchange Act, including amendments to Exchange Act Rule 15c3-1, which established an alternative method of computing net capital for broker-dealers. The NYSE amendments also reflect amendments to CFTC rules under the Commodities Exchange Act with respect to minimum net capital requirements for FCMs.

Information Memo 07-76, SEC and NYSE Amendments Concerning Short Sale Rules, Issued July 23, 2007

.90 The SEC issued a release adopting amendments to its rules governing short sales. Specifically, the SEC amendments eliminate Rule 10a-1 under the Exchange Act. Additionally, the amendments add Rule 201 of Regulation SHO to provide that no price test, including any price test by any SRO, shall apply to short selling in any security. Rule 200(g) of Regulation SHO, as amended, removes the requirement that a broker-dealer mark a sell order of an equity security as *short exempt* if the seller is relying on an exception from Rule 10a-1, or any price test of any exchange or national securities association as this rule is no longer necessary with the elimination of the price test requirements.

Information Memo 07-79, Changes to Disciplinary Proceedings at NYSE Regulation as a Result of the Regulatory Consolidation with NASD, Issued July 30, 2007

.91 The purpose of this information memo is to advise members and member organizations of changes to disciplinary procedures at NYSE regulation that will be implemented in connection with the regulatory consolidation of NASD and certain member firm functions from NYSE regulation.

National Futures Association

.92 The NFA amended several of its rules governing Forex Dealer Members (FDMs). These amended requirements include the following:

- Effective March 31, 2007, the NFA replaced an FDM capital requirement calculation that had been based on 1 percent of the total net notional value of retail customer positions with a new capital requirement calculation based on 5 percent of liabilities to retail off-exchange foreign currency (forex) customers.
- Effective July 1, 2007, FDMs must calculate the amount owed to U.S. customers for forex transactions and hold assets equal to or in excess of that amount at a qualifying institution in the United States or in a money center country (as defined in CFTC Regulation 1.49).
- Effective December 21, 2007, the minimum net capital requirement for FDMs will increase from $1 million to $5 million. Other NFA amendments effective on December 21, 2007, will eliminate concentration charges for FDMs and will be replaced by restrictions on the types of firms with which an FDM may maintain assets and cover its exposure for purposes of the haircuts specified in CFTC Regulation 1.17.

Recent Concerns of Regulators

.93 Over the past several years during examinations of broker-dealers and FCMs, regulators encountered a number of issues, some of which are discussed in the following paragraphs.

SEC Compliance Alert

.94 The SEC released a compliance alert in June 2007 that identifies areas that have been of concern during recent compliance examinations. Listed in the following paragraphs in summary form are compliance issues found in broker-dealer firms. Also included in the compliance alert are issues found at investment advisers. Readers can view the full text of the compliance alert for complete information by accessing www.sec.gov/about/offices/ocie/complialert.htm.

Sales of Section 529 College Savings Plans

.95 Many firms appeared to lack adequate written supervisory procedures or supervisory processes to review the 529 plan transactions in customer accounts. Also, it did not appear that the firms had incorporated training for registered representatives or supervisors with respect to the specific factors that could impact the suitability of the firm's recommendations with respect to 529 plans.

Sales of Collateralized Mortgage Obligations

.96 Examiners found deficiencies in the disclosures provided to customers in connection with Collateralized Mortgage Obligation (CMO) transactions. These deficiencies were in both content and type of materials provided to customers. They also found a lack of supervisory procedures to review the adequacy of disclosures made to investors in connection with the sale of CMOs, indications that CMOs were sold to unsuitable customers, and some instances of undisclosed markups that appeared to be excessive.

Sales of Real Estate Investment Trusts

.97 Inadequate and potentially misleading disclosures to investors were found concerning the risk of the investments, the possible future public trading market for the real estate investment trusts (REITs), and their liquidity. Deficiencies were also noted relating to the valuation of the investments in REITs, the source of dividend payments, sales of the securities prior to registration, lack of supervision over registered representatives selling REITs, and potential conflicts of interest arising from excessive noncash compensation paid by sponsors of the REIT.

Supervisory Procedures to Ensure Compliance with Regulation SHO

.98 Many firms were found to have inadequate written supervisory procedures to ensure compliance with regulation SHO. Consequently, the firms were not in compliance with various requirements.

Charges in Separately Managed Accounts

.99 Examinations found instances where customers had been overcharged for separately managed account fees. It appeared that control procedures were lacking to ensure that the fees assessed to customers were consistent with the charges outlined in customer agreements and offering documents.

Part-Time Financial and Operations Principles

.100 During examinations of broker-dealers employing a part-time FINOP, examiners found that some firms appeared to have inaccurate books and records that resulted in erroneous financial reports to regulators. Instances were found where the part-time FINOP had no role in the actual supervision or creation and maintenance of various books and records, as required by NASD.

Expense Sharing Arrangements

.101 Targeted examinations of broker-dealers that utilized expense sharing arrangements revealed various deficiencies, including indications that certain firms operated while failing to maintain the required minimum net capital. The deficiencies were caused by the inappropriate shifting of a liability from the broker-dealer to an affiliate. Also, some firms failed to maintain adequate expense-sharing agreements.

CFTC Concerns

Letters of Credit

.102 Although exchange or clearinghouse rules may permit letters of credit to be accepted as performance bond or margin, letters of credit cannot be used to offset or secure any FCM customer deficit. The risk of improperly including letters of credit in regulatory reporting may be increased by the use of back office applications that are provided by third party service providers. All FCMs are reminded that:

- Letters of credit are not to be reported as segregated assets under CFTC Regulation 1.20 or as set-aside assets under Part 30 of the regulations of the CFTC. When computing the amount of customer funds required to be held in segregated or secured accounts, letters of credit must be excluded and cannot be used to offset any customer deficit.
- Letters of credit are not satisfactory collateral under CFTC Regulation 1.17 for securing any form of receivable owed to the FCM, including a receivable arising from a deficit in the account of a customer or noncustomer.

Maintenance of Minimum Financial Requirements and Notification Requirements

.103 CFTC Regulation 1.17 specifies minimum capital requirements, and CFTC Regulation 1.12 specifies the conditions requiring FCMs to give notice of certain events occurring in a firm's financial or operational condition, changes or anticipated changes in capital balances, and how and when such notices are to be given.

.104 For example, Regulation 1.12(g) requires that an FCM provide written notice of a substantial reduction in capital as compared to that last reported in a financial report filed with the CFTC pursuant to Regulation 1.10. If such reduction would be caused by a withdrawal of equity capital of 30 percent or more, notice must be provided at least 2 days prior to the withdrawal. For any reduction in net capital of 20 percent or more, notice must be provided within 2 days after the reduction.

.105 FCMs should establish procedures to ensure that the notices required by CFTC regulations are filed with the CFTC within the established time frames set forth in the regulations. In particular, it is a violation of CFTC rules for an FCM to not file a notice of a withdrawal of equity capital of 30 percent or more at least 2 days prior to such withdrawal. FCMs should not provide the notice after the filing of the financial statements in which the withdrawal is reflected. Failure to make a timely filing negates the purpose of the rule, which is designed to alert the CFTC to a possible change in an FCM's financial condition. Notices should be filed promptly when due and provide an explanation for the decrease in net capital.

.106 FCMs also should consider including details in the comments section of the electronically filed financial report affected by reporting when they have made or intend to make the filing required by Regulation 1.12(g).

Segregation of Customer Funds in Multiple Currencies

.107 FCMs must maintain compliance with CFTC recordkeeping, computation, and segregation requirements applicable to customer funds held in multiple currencies. Regulation 1.20 requires that all customer funds be separately accounted for and segregated as belonging to commodity customers and deposited in an account that clearly identifies those funds as such. Regulation 1.32 requires each FCM to compute as of the close of each business day, on a currency-by-currency basis:

1. The total amount of customer funds on deposit in segregated accounts on behalf of commodity and commodity option customers;
2. The amount of such customer funds required to be on deposit in segregated accounts; and
3. The amount of the FCM's residual interest in such customer funds.

.108 CFTC Regulation 1.49 specifies the conditions under which the FCM's obligations to a customer may be denominated in currencies other than the U.S. dollar. The regulation also specifies the geographic locations in which customer funds may be held and the required qualifications for permissible depositories in those locations.

.109 Some areas of recent focus in regard to these regulations include the treatment of customer-owned securities that are denominated in non-U.S. currencies, and which are held in depositories outside of the United States. All FCMs should take steps to ensure that such depositories satisfy all of the required criteria set forth in Regulation 1.49(d)(3). FCMs should also ensure that such customer owned securities are included in the segregation computation for the currency in which they are denominated.

.110 Furthermore, FCMs should ensure that offsets to customer account deficits that are denominated in multiple currencies are computed in accordance with Rule 1.49(e). At the close of each business day, Rule 1.49(e) requires the FCM to maintain in segregated accounts sufficient U.S. dollars, held in the United States, to meet all U.S. dollar obligations, and also sufficient funds in each other currency to meet obligations in such currency, with certain permitted substitutions:

1. U.S. dollars held in the United States may be used to meet obligations denominated in any other currency.

2. "Money center" currencies and U.S. dollars held in money center countries may be held to meet obligations denominated in currencies other than the U.S. dollar.

Foreign Currency Exchange Transactions (Forex)

.111 CFTC staff issued an advisory on August 30, 2007, concerning retail off-exchange foreign currency (forex) futures or option transactions.

.112 The advisory addresses the following issues: (1) registration requirements for associated persons of firms registered as IBs, commodity trading advisors, and CPOs that are involved in forex transactions; (2) the permissibility of certain unregistered affiliates of an FCM to act as proper counterparties in forex transactions; (3) claims that forex customer funds are segregated; (4) introducing entities acting as FCMs; (5) the applicability of the IB guarantee agreement to forex transactions and prohibiting guaranteed IBs from introducing forex transactions to an FCM that is not its guarantor FCM; (6) prohibiting forex account statements of an FCM's unregistered affiliate from being included in the FCM's account statements to its customers; and (7) prohibiting retail customers from acting as counterparties to each other in forex transactions.

.113 In addition, on May 7, 2007, the CFTC and the North American Securities Administrators Association issued a joint investor alert to warn of the dangers facing retail investors who are lured into forex trading frauds.

.114 The regulators cautioned investors that off-exchange forex trading by retail investors is at best extremely risky, and at worst, plagued by outright fraud.

CFTC Annual "Dear CPO" Letter

.115 On January 31, 2007, CFTC staff issued its annual letter to CPOs outlining key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. The letter emphasized 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.

.116 The following are major concerns addressed in the letter:

- Due dates of commodity pool financial filings—late filings
- Other filings by CPOs regarding:
  - — Replacement of an accountant, election of fiscal year, and
  - — Regulation 4.13 exemptions
- Compliance with U.S. generally accepted accounting principles (GAAP)
- Requests for limited relief from U.S. GAAP compliance for certain offshore commodity pools
- Initial annual reports and final annual reports
- Accounting developments:
  - — Financial Accounting Standards Board (FASB) Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity,* implementation and its impact on participants' redemptions
  - — Alternative investments, audit considerations
  - — AICPA technical guidance regarding offering costs
  - — FASB Statement No. 157, *Fair Value Measurements*
- Requests for confidential treatment of commodity pool annual reports

.117 The letter also noted that the CFTC's Division of Clearing and Intermediary Oversight issued similar letters in prior years, which are available on the CFTC's Web site at www.cftc.gov. Those letters should be consulted with respect to commodity pool annual financial statements and reporting. In addition, CFTC interpretations and staff letters providing guidance from 1995 forward are also available there. In particular, CFTC Interpretive Letter 94-3, "Special Allocations of Investment Partnership Equity," addresses how a CPO should report such allocations to the general partner in a commodity pool's financial statements.

CFTC "Dear FCM" Letter

.118 On February 8, 2007, CFTC staff issued a letter to FCMs outlining key reporting issues and common reporting deficiencies found in annual audited financial reports for FCMs. The letter emphasized 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 FCMs. CFTC staff suggested that FCMs share the letter with their independent auditors.

.119 Issues addressed in the letter include the following:

- Filing deadline: CFTC Regulation 1.10(b)(1)(ii)
- Accountant's report on material inadequacies: CFTC Regulation 1.16(c)(5)
- Paper versus electronic filing: CFTC Regulation 1.10(b)(2)(iii)
- Reporting material differences between unaudited and audited financial reports: CFTC Regulation 1.10(d)(2)(vi)
- Exchange memberships excluded from current assets: CFTC Regulation 1.17(c)(2)(x)
- Required oath or affirmation: CFTC Regulation 1.10(d)(4)
- Replacement of Accountants: CFTC Regulation 1.16(g)

.120 The letter is available on the CFTC's Web site at www.cftc.gov.

Audit and Attestation Issues and Developments

.121 Authoritative audit guidance issued during the past year that affects a wide variety of entities can be found in this alert in the section titled "Recent Auditing and Attestation Pronouncements and Related Guidance." Guidance issued this year that is of specific interest to the securities industry can be found in the following paragraphs. The following summary is for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable rule or release.

AICPA Practice Aid, *Alternative Investments—Audit Considerations*

.122 Over the past several years, many companies have dramatically increased their investment in financial instruments that do not have a readily determinable market value (that is, investments not listed on national exchanges or on over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or the NASDAQ System). This practice aid addresses challenges associated with auditing such investments. These investments include private investment funds meeting the definition of an investment company under the provisions of the AICPA Audit and Accounting Guide *Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity pools, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds. Collectively, these types of investment funds are commonly referred to as alternative investments. Alternative investments may be structured as limited partnerships, limited liability corporations, trusts, or corporations.

.123 This practice aid was developed to provide additional guidance to auditors of investor entities as to how the auditor may obtain sufficient appropriate audit evidence in order to conclude that the financial statements are free of material misstatement. This nonauthoritative practice aid will assist auditors in auditing alternative investments. The practice aid includes guidance on the following:

- General considerations pertaining to auditing alternative investments
- Addressing management's financial statement existence assertion
- Addressing management's financial statement valuation assertion
- Management representations
- Disclosure of certain significant risks and uncertainties
- Reporting

.124 The practice aid also includes the following appendixes:

- Appendix 1, "Example Confirmation for Alternative Investments"
- Appendix 2, "Illustrative Examples of Due Diligence, Ongoing Monitoring, and Financial Reporting Control"

.125 You can download the practice aid at www.aicpa.org/download/members/div/auditstd/Alternative_Investments_Practice_Aid.pdf.

Accounting Issues and Developments

.126 Authoritative guidance issued in the past year that affects a wide range of entities is located in the section titled "Recent Accounting Pronouncements and Related Guidance," found in this alert. Guidance that is of special interest to the securities industry can be found below. While some of this guidance was issued in 2006, its full effect is now being felt. Therefore, it is being included again in this year's alert.

Fair Value Measurements

FASB Statement No. 157

.127 On September 15, 2006, the FASB issued FASB Statement No. 157 which provides enhanced guidance for using fair value to measure assets and liabilities. FASB Statement No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances. The following is a brief discussion of some of the provisions of FASB Statement No. 157 that should be of interest to broker-dealers and their auditors.

.128 FASB Statement No. 157 clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

.129 FASB Statement No. 157 establishes the fair value hierarchy, which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

.130 Among other matters, FASB Statement No. 157 precludes the use of a blockage factor. Paragraph 27 of FASB Statement No. 157 provides that:

> "If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price."

.131 Footnote 11 to this paragraph states that, "The guidance in this Statement applies for positions in financial instruments (including blocks) held by all entities, including broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries."

.132 The guidance in FASB Statement No. 157 applies for derivatives and other financial instruments measured at fair value under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, at initial recognition and in all subsequent periods. Therefore, FASB Statement No. 157 nullifies the guidance in footnote 3 of Emerging Issues Task Force (EITF) Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," which applied for derivatives (and other) instruments measured at fair value at initial recognition under FASB Statement No. 133. That guidance precluded immediate recognition in earnings of an unrealized gain or loss, measured as the difference between the transaction price and the fair value of the instrument at initial recognition, if the fair value of the instrument was determined using significant unobservable inputs. FASB Statement No. 157 provides, however, that for unobservable inputs, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Consistent with that objective, FASB Statement No. 157 clarifies that the fair value measurements should be adjusted for risk, that is, the amount market participants would demand because of the risk (uncertainty) inherent in a particular valuation technique used to measure fair value (such as a pricing model) or the risk inherent in the inputs to the valuation technique (a risk premium notion), or both. Accordingly, a measurement (for example, a "mark-to-model" measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability.

.133 FASB Statement No. 157 also amends FASB Statement No. 133 to remove the similar guidance to that in EITF Issue No. 02-3, which was added by FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*.

.134 FASB Statement No. 157 provides that if an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances should be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2, or 3). FASB Statement No. 157 does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

.135 FASB Statement No. 157 clarifies that market participant assumptions also include assumptions about the effect of a restriction on the sale or use of an asset. It provides that a fair value measurement for a restricted asset should consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset.

.136 FASB Statement No. 157 also clarifies that a fair value measurement for a liability reflects its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value under other accounting pronouncements, including FASB Statement No. 133.

.137 FASB Statement No. 157 also expands disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition. The disclosures focus on the inputs used to measure fair value and for recurring fair value measurements using significant unobservable inputs (within Level 3 of the fair value hierarchy), the effect of the measurements on earnings (or changes in net assets) for the period. FASB Statement No. 157 encourages entities to combine the fair value information disclosed under FASB Statement No. 157 with the fair value information disclosed under other accounting pronouncements, including FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, where practicable.

.138 FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007,[2] and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including financial statements for an interim period within that fiscal year. You can access FASB Statement No. 157 online at www.fasb.org/pdf/fas157.pdf.

Fair Value Measurement—Practical Guidance

.139 As companies implement the fair value guidance, they may encounter unanticipated issues. One of these issues has arisen due to the current conditions in the credit markets. The AICPA Center for Audit Quality

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[2] FASB is proposing a 1 year deferral for the implementation of FASB Statement No. 157 for certain nonfinancial assets and liabilities. This delay is not yet approved and readers should be alert for further developments.

(CAQ) issued a White Paper on FASB Statement No. 157 entitled "Measurements of Fair Value in Illiquid (or Less Liquid) Markets" in October 2007. The purpose of the white paper is to discuss issues associated with the measurement of fair value under existing GAAP in the context of illiquid (or less liquid) market conditions that currently exist in many segments of the credit markets. The paper can be accessed online at www.thecaq.org/members/alerts/CAQAlert2007_51_10032007.pdf.

FASB Statement No. 159

.140 Subsequent to the issuance of FASB Statement No. 157, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.141 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as long as the entity also elects to apply the provisions of FASB Statement No. 157 and has not yet issued financial statement, including required notes to those financial statements, for any interim period for the fiscal year of adoption. The choice to adopt early should be made within 120 days of the beginning of the fiscal year of adoption (for calendar year end entities, by April 2007). The FASB and SEC have expressed concern in the way some early adopters have applied the transition provisions of the standard. The AICPA CAQ issued an alert on this development in April, 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard such as this is applied in a good faith manner consistent with those objectives and principles. Specifically the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FASB Statement No. 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed online at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*

.142 In June 2006, the FASB issued FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

.143 FIN 48 was issued to reduce the significant diversity in practice. A company's tax positions can change over time from a myriad of variables, for example, IRS developments, state taxing authorities, or tax court cases. Companies were recording uncertainties in different ways. Some companies had been assessing a position being supported under a tax audit, some had also included the probability of an audit, and some companies simply recorded tax assets and liabilities based on what was filed on their returns. Additionally, some companies recorded tax reserves for contingent tax liabilities.

.144 The scope of FIN 48 applies to all tax positions. The interpretation assumes that a company cannot factor in the probability of being audited. Therefore, for purposes of determining the likelihood of being sustained, the taxpayer has to presume the position will be examined by taxing authorities. Consequently, the tax benefit of a position that would not be sustained under audit cannot be recorded.

.145 Prior to the issuance of FIN 48, management's common approach was to create an inventory of uncertain tax positions and evaluate them under FASB Statement No. 5, *Accounting for Contingencies*. Because FIN 48 now provides guidance, FASB Statement No. 5 no longer applies to uncertain tax positions. However, for clarification, FIN 48 does not in any way alter the requirement in FASB Statement No. 109, *Accounting for Income Taxes*, to assess the need for a valuation allowance for deferred tax assets.

.146 Only tax positions that meet the more likely than not recognition threshold, as defined, may be recognized or continue to be recognized upon adoption of FIN 48. The cumulative effect of applying the interpretation for the first time is reported as an adjustment to the opening balance of retained earnings for that fiscal year, presented separately. This interpretation is effective for fiscal years beginning after December 15, 2006.[3]

.147 For calendar year corporations, the new rules would seem to initially take effect with first quarter 2007 results. However, the new rules require calendar year corporations to have a "clean" starting point for their tax accounts at January 1, 2007. In other words, the deferred tax asset and deferred tax liability accounts on that date must be determined in accordance with the standards of FIN 48. Note that companies that do not file quarterly reports may be able to put compliance off for a year.

.148 The IRS has recognized that some taxpayers may wish to request a greatly accelerated examination and resolution before the end of their current fiscal year of "uncertain tax positions" taken in filed returns or expected to be taken in tax returns yet to be filed, or both. According to information received by the AICPA, the IRS has put procedures in place to quickly respond to taxpayer requests to resolve some uncertain tax positions prior to the end of their current fiscal year. The IRS has provided guidance and direction to field teams for taxpayers under examination which can be viewed online at www.irs.gov/businesses/corporations/article/0,,id=163496,00.html. The IRS has also established procedures for taxpayers whose returns are not under examination as well as for taxpayers whose returns have not yet been filed.

.149 Practitioners may find it helpful to refer to the recently issued AICPA *Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48*, which includes highlights of the interpretation and its implications for in-house accountants, auditors, and tax advisers. It is not authoritative, but is intended to assist practitioners in quickly understanding the requirements of FIN 48. The practice guide can be accessed online at www.tax.aicpa.org/Resources/Professional+Standards+and+Ethics/Practice+Guide+on+Accounting+for+Uncertain+Tax+Positions+Under+FIN+48.htm.

Other Guidance

Statement of Position 07-1, Clarification of the Scope of the Audit and Accounting Guide *Investment Companies* and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies

.150 This Statement of Position (SOP) provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies* (guide). For those entities that are investment companies under this SOP:

- The provisions of the guide should be used in presenting the financial statements.

[3] FASB has proposed a 1 year deferral of the effective date of FIN 48 for nonpublic entities, including nonprofit organizations, to fiscal years beginning after December 15, 2007. Readers should be alert for further developments.

- The guide should be utilized to determine whether the accounting principles of the guide should be retained by a parent company in consolidation or by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity (equity method investor).
- Certain disclosures are required by parent companies and equity method investors in investment companies that retain investment company accounting in the parent company consolidated financial statements or the financial statements of an equity method investor.

.151 This guidance was to be effective for years beginning on or after December 15, 2007. However, at its October 17, 2007 Board meeting, FASB proposed to indefinitely defer the effective date of SOP 07-1 to enable FASB staff to address certain implementation issues that have been brought to their attention. In addition, for entities that have not yet adopted the provisions of SOP 07-1, early adoption will be prohibited. These decisions will be documented in a proposed FASB Staff Position that will have a 30 day comment period. Readers should be alert for further developments.

FASB Staff Position FIN 39-1

.152 FASB Staff Position (FSP) FIN 39-1, *Amendment of FASB Interpretation No. 39*, is effective for fiscal years beginning after November 15, 2007. This FSP amends paragraph 3 of Interpretation 39, *Offsetting of Amounts Related to Certain Contracts*, to replace the terms *conditional contracts* and *exchange contracts* with the term *derivative instruments*, as defined in FASB Statement No. 133. It also amends paragraph 10 of Interpretation 39 to permit an entity to offset fair value amounts recognized for the right to reclaim cash collateral, or the obligation to return cash collateral, against fair value amounts recognized for derivative instruments executed with the same counterparty under the same master netting arrangement. See www.fasb.org/pdf/fsp_fin39-1.pdf.

FASB Staff Position EITF 00-19-2

.153 FSP EITF 00-19-2, *Accounting for Registration Payment Arrangements*, is effective for financial statements issued for fiscal years beginning after December 15, 2006, and interim periods within those fiscal years. This FSP clarifies that a contingent obligation to make future payments, or otherwise transfer consideration under a registration payment arrangement, should be separately recognized and measured in accordance with FASB Statement No. 5. This accounting treatment applies in situations where the registration payment arrangement is issued as a separate agreement and also in situations where the arrangement is included as a provision of a financial instrument or other agreement. See www.fasb.org/pdf/fsp_eitf00-19-2.pdf.

Statement 133 Implementation Issue No. B40

.154 Statement 133 Implementation Issue No. B40, *Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interest in Prepayable Financial Assets*, sets forth the circumstances where a securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of FASB Statement No. 133. The objective of the guidance is to provide a narrow scope exception from paragraph 13(b) for securitized interests that contain only an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets and that meet the criteria set forth. See the full text of the guidance online at www.fasb.org/derivatives/issueb40.shtml for complete information.

Statement 133 Implementation Issue No. G26

.155 Statement 133 Implementation Issue No. G26, *Cash Flow Hedges: Hedging Interest Cash Flows on Variable-Rate Assets and Liabilities That are not Based on a Benchmark Interest Rate*, clarifies two situations related to variable-rate financial assets or liabilities for which the interest rate is not based solely on an index. The issue addressed relates to situations where the interest rate is set through an auction process. Please see the full text of the guidance online at www.fasb.org/derivatives/issueg26.shtml for complete information.

AICPA Technical Practice Aid, Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments*, working draft as of December 1, 2006*

.156 This working draft was prepared by the Analyzing Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments Task Force and the staff of the AICPA. Its content reflects what the authors believe is existing authoritative literature as of December 1, 2006. Readers are reminded that there are several projects currently in process at the FASB that may affect the contents of this Technical Practice Aid draft, and they must be alert to any changes. This draft has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA, the FASB, or the staff of the SEC and has no official or authoritative status.

.157 This Technical Practice Aid draft is not intended to provide practitioners with interpretative guidance or to describe the accounting for specific instruments. Rather, it is intended to assist practitioners in identifying the scope of and the interrelationships between the various relevant accounting pronouncements. To accomplish that goal, the practice aid is a roadmap addressing the accounting considerations that should be considered in analyzing freestanding and embedded derivative financial instruments at issuance and on an ongoing basis.

.158 This working draft is available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/Working+Draft+of+Convertible+Debt+Convertible+Preferred+Shares+Warrants+and+Other+Equi.htm.

Recent Auditing and Attestation Pronouncements and Related Guidance

.159 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.160 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A), to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120) • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	See the "AICPA Risk Assessment Standards" section in this alert.
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325.01–.04), which interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.
Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330.01–.06), which interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.
TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This PA responds to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.
AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This PA provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditor's report.
PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This standard replaces the PCAOB's previous internal control standard, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.
PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This rule requires a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the SEC or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm's independence, and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524. This rule is effective for audits of fiscal years ending on or after November 15, 2007.

Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Conforming Amendments to the Interim Auditing Standards Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in Appendix 3 of PCAOB Release No. 2007-005A at www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.
PCAOB Report, *Report on the Second-Year Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report is based on PCAOB inspections that looked at parts of approximately 275 audits of internal control over financial reporting by registered public accounting firms. Inspections focused on four areas: integrating the audits of financial statements and internal control, using a top-down approach, using the work of others, and assessing risk.
PCAOB Report, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (AICPA, *PCAOB Standards and Related Rules*, Select SEC-approved PCAOB Releases) Issue Date: January 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report focuses on aspects of the PCAOB's interim auditing standards that address the auditor's responsibility with respect to fraud, specifically AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.
PCAOB Staff Questions and Answers, *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	Topics covered include the following: • The application of Rule 3522(a) when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm • Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
	• Whether a registered public accounting firm's independence is affected by the IRS's subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b) • Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself • Clarification of the term *other change in employment event* as it relates to Rule 3522(c)
PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 100—PCAOB Staff Questions and Answers") Issue Date: October 2006 (Applicable to audits conducted in accordance with PCAOB standards)	The guidance provides direction for auditing a company's estimation of the fair value of stock options granted to employees pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment*, which became applicable for financial statements of companies with fiscal years ending on or after June 15, 2006.

The Auditor's Communication With Those Charged With Governance

.161 In December 2006, the Auditing Standards Board (ASB) issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and is effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to 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. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.162 SAS No. 114 recognizes the importance of effective two-way communication to the audit. It provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires significant matters communicated with those charged with governance to be documented.

Identifying Those Charged With Governance

.163 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those 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.

.164 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.165 Because there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.166 In May 2006, the AICPA ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued, the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. However, with the adoption of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, the PCAOB redefined these terms, which now differ from SAS No. 112.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.
- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, and identifies indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.
- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.
- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the report release date.
- Contains illustrative written communications to management and those charged with governance.

How Revisions of SAS No. 112 Affect Practice

.167 As auditors gain a better understanding of what needs to be communicated to management and those charged with governance, there may be more control deficiencies that are identified as significant deficiencies and material weaknesses, and that are then communicated to management and those charged with governance. Auditors may emphasize and therefore spend more time evaluating identified control deficiencies than in the past.

Discussions With Management and Others

.168 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. Auditors may have to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor who does not provide attest services for the client can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.169 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of material weaknesses. Another reason is that auditors have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in written communication as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.170 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented, detected, and corrected by the client.

Issues for Audits of Smaller Entities

.171 One issue that has arisen in audits of smaller entities is the increase in costs as a result of the time the auditor spends documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.172 Another issue that has caused concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of a material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, detecting, or correcting material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, because doing so would impair independence.[4] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.173 The new requirements of SAS No. 112 introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing.

.174 The AICPA has published the AICPA Audit Risk Alert titled *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in implementation of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or by going online at www.cpa2biz.com.

AICPA Risk Assessment Standards

.175 In March 2006, the AICPA ASB issued eight SASs referred to as the risk assessment standards (SAS Nos. 104–111). Although the SASs include many of the underlying concepts and detailed performance requirements contained in existing standards, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risks of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between the risks, controls, audit procedures, and conclusions. The risk assessment standards are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier application permitted. The following table lists the eight SASs and their effects on existing standards.

Statement on Auditing Standards	***Effect on Existing Standards***
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")* (AICPA, *Professional Standards*, vol. 1, AU sec. 230)	This statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230A).
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	This statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A).
SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)	This statement supersedes SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326A).

(continued)

[4] See Ethics Ruling 101-3, "Performance of nonattest services," of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

Statement on Auditing Standards	*Effect on Existing Standards*
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)	This statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312A).
SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)	This statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 310), and supersedes SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A).
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314)	This statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1, AU sec. 318)	This statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)	This statement amends SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350A).

Key Provisions of the Risk Assessment Standards

.176 Whether due to error or fraud, the new risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks that may lead to a material misstatement in the client's financial statements and any mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations of the Treadway Commission's [COSO] framework, www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs will most likely result in significant changes to firm audit methodologies and the training of personnel. Therefore, it is recommended that auditors allow ample time in advance of the required implementation date. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) by calling the AICPA at (888) 777-7077 or by going online at www.cpa2biz.com.

Companion Audit Guide

.177 In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or by going online at www.cpa2biz.com.

Other Audit Developments

Audit Documentation Technical Practice Aids

.178 In May 2007, the ASB issued two Technical Practice Aid (TPA) Technical Questions and Answers (TIS) related to SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which was issued in December 2005.

.179 TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.180 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*), discusses whether the provisions of SAS No. 103 related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Practice Alert No. 07-1, Dating of the Auditor's Report and Related Practical Guidance

.181 A key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms, an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.182 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date
- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.183 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf.

PCAOB Auditing Standard No. 5

.184 On May 24, 2007, the PCAOB adopted Auditing Standard No. 5, which supersedes its Auditing Standard No. 2. Also adopted was an independence rule relating to the auditor's provision of internal control related nonaudit services and conforming amendment resulting from the issuance of PCAOB Auditing Standard No. 5. The SEC approved the standard on July 25, 2007.

.185 The PCAOB has closely monitored the implementation of Auditing Standard No. 2 and came to two conclusions:

1. The audit of internal control over financial reporting has produced significant benefits related to corporate processes and controls.
2. These benefits have come at a significant and higher than anticipated cost, and at times, the effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

.186 The PCAOB adopted the new Auditing Standard No. 5 to replace Auditing Standard No. 2 with the primary objective of focusing the auditor on matters most important to internal control. Goals of this new standard are to eliminate unnecessary procedures, to simplify and shorten the standard by reducing detail and specificity, and to make the audit more scalable for smaller and less complex companies. The following are some examples of important differences between Auditing Standard No. 5 and Auditing Standard No. 2:

- The new standard is less prescriptive, with fewer mandatory requirements and more reliance on auditor judgment.
- The new standard makes the audit scalable so it can change to fit the size and complexity of any company.
- The new standard directs the auditor to focus on what matters most and eliminates unnecessary procedures from the audit.
- The new standard includes a principles-based approach to determining when and to what extent the auditor can use the work of others.

.187 The adopted standard will do the following, among other things:

- Direct the auditor to the most important controls and emphasize the importance of risk assessment using a top-down approach
- Emphasize fraud controls, with an emphasis on assessing fraud risk in the planning process and additional guidance on the types of controls that may address fraud risk
- Identify management fraud as an area of higher risk, directing the auditor to focus more attention in this area
- Recalibrate the walkthrough requirement
- Permit consideration of knowledge obtained during prior audits
- Revise the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness
- Adopt communication requirements, which require, among other things, that the auditor communicate, in writing, any material weaknesses identified to management and the audit committee, and to communicate any identified significant deficiencies, in writing, to the audit committee
- Direct the auditor to tailor the audit to reflect attributes of smaller and less complex companies

- Remove the requirement to evaluate management's process, which the PCAOB believes could contribute to a checklist approach to compliance by the auditors
- Provide auditors with further guidance regarding scoping decisions for multiple location audits

.188 Auditing Standard No. 5 is effective for audits of internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002 for fiscal years ending on or after November 15, 2007. Early adoption is permitted and encouraged. Please see www.pcaob.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.5.aspx for the full release document.

.189 Upon approval of the new standard by the SEC on July 25, 2007, the PCAOB announced that it is undertaking several initiatives to support the successful implementation of the standard. These initiatives include working closely with the audit firms early in their process as they evaluate how the new standard will affect their firms' audits of internal control. Other initiatives include continued outreach to public companies and smaller audit firms regarding the new standard. See full text of the press release at www.pcaob.org/News_and_Events/News/2007/07-25.aspx.

Rule 3525, Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

.190 The PCAOB also adopted a new rule related to the auditor's responsibilities when seeking audit committee pre-approval of internal control related nonaudit services. The rule is intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence. Specifically, the public accounting firm shall describe, in writing, the scope of the service and submit to the audit committee, as well as discuss with the audit committee, the potential effects of the service on the firm's independence. Registered firms are also required to document the substance of such discussions in writing. This rule is effective for audits of fiscal years ending on or after November 15, 2007 (the same effective date as Auditing Standard No. 5). The full text of this rule can be found online at www.pcaob.org/Rules/Rules_of_the_Board/Rule_3525.pdf.

Conforming Amendments to Interim Auditing Standards

.191 In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments due to the issuance of Auditing Standard No. 5 can be found online at www.pcaob.org/Rules/Rules_of_the_Board/Conforming_Amendments_AS5.pdf#page=1.

.192 For more information on PCAOB proposed rules and standards, please see *SEC and PCAOB Alert—2007/08*, which is available at www.cpa2biz.com.

Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud

.193 On January 22, 2007, the PCAOB issued a report that addresses the auditors' responsibility as it relates to fraud, principally as it relates to AU Section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*). The PCAOB has identified areas (noted during the course of inspections) that auditors should focus on during the audit. The report is not changing any existing standards, but is focusing on areas that need special attention during an audit as it relates to fraud. Major topics discussed include the following:

- Auditors' overall approach to the detection of fraud
- Brainstorming sessions and fraud-related inquiries
- Auditors' response to fraud risk factors

- Financial statement misstatements
- Risk of management override of controls
- Other areas to improve fraud detection

.194 The full report can be accessed online at www.pcaob.org/Inspections/Other/2007/01-22_Release_2007-001.pdf.

Recent AICPA Independence and Ethics Pronouncements

.195 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.196 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. As indicated below, some of these items are described more fully in a prior section of this alert titled, "Accounting Issues and Developments." 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115* See the information in "Fair Value Measurements" in the "Accounting Issues and Development" section of the alert.
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements* See the information in "Fair Value Measurements" in the "Accounting Issues and Development" section of the alert.
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* See the information the "Accounting Issues and Development" section of the alert.
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.

Recent Accounting Pronouncements and Related Guidance	
FASB Staff Positions (FSPs) (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA Statement of Position (SOP) 07-1 (AICPA, *Technical Practice Aids*, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* See the information in "Other Guidance" in the "Accounting Issues and Development" section of the alert.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.197 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the securities industry were briefly explained in the section of this alert titled "Accounting Issues and Developments."

On the Horizon

.198 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to the securities industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.199 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. 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 in addition to those discussed here. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Auditing Pipeline—Nonissuers

Revision of AICPA Practice Aid, Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools

.200 The Commodity Practice Aid Task Force of the AICPA is in the process of revamping this practice aid to reflect changes in accounting and auditing guidance and regulatory rules that have occurred since the original issuance of this publication. The revised practice aid will provide 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. Readers should be alert to further developments.

ASB Clarity Project

.201 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB approved for exposure a discussion paper titled *Improving the Clarity of ASB Standards*. This discussion paper seeks feedback on proposed changes to the standards, including the following:

- Establishing objectives for each of the standards, and the auditor's obligations related to the objectives
- Structural and drafting improvements to make the standards easier to read and understand
- Inclusion, in the explanatory material of the standards, of special considerations related to audits of governmental entities and small entities
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards

.202 The period to comment ended June 15, 2007. The discussion paper can be accessed online at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

Convergence With International Standards

.203 The ASB has created a number of task forces charged with monitoring specific activities of the International Auditing and Assurance Standards Board (IAASB) and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of International Standards on Auditing (ISA). The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.204 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, the ASB previously decided to defer to issuance of a final revised AT section 501 until the PCAOB issued its amendments, and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www .aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of **Present Fairly in Conformity With Generally Accepted Accounting Principles**

.205 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles,* for Nongovernmental Entities. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards titled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69, The Meaning *of Present Fairly in Conformity With Generally Accepted Accounting Principles* [AICPA, *Professional Standards*, vol. 1, AU sec. 411]) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www.fasb.org. The ASB will issue its final SAS coincidentally with the FASB's and PCAOB's issuance of their final standards.

Auditing Pipeline—Issuers

.206 Guidance issued by the PCAOB is included in the section of this alert titled "Recent Auditing and Attestation Pronouncements and Related Guidance." For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), mentioned previously.

Accounting Pipeline

.207 The following are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year alert have not been finalized as of the date of this writing, and thus are included again.

Business Combinations

.208 Phase one of the business combination project resulted in the issuance of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*. In those statements, the FASB eliminated the use of the pooling of interests method of accounting for business combinations and addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. The objective of phase two of this project is to standardize business combination accounting through the convergence of the FASB and International Accounting Standards Board (IASB) accounting standards and by reconsidering the existing guidance for the purchase method of accounting for business combinations. Among the main proposals are the following:

- All acquisitions of businesses be measured at the fair value of the business acquired
- Substantially all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date
- Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations

.209 In June 2005, the FASB and IASB issued a number of exposure drafts, for which comment periods ended in October 2005. Redeliberations began in January 2006 and were completed in June 2007. The FASB and IASB expect to issue final statements during the fourth quarter of 2007. Four standards are expected to be issued:

- Proposed FASB Statement No. 141(R) and International Financial Reporting Standard (IFRS) No. 3(R), *Business Combinations*
- Proposed FASB Statement No. 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*
- Proposed International Accounting Standard (IAS) Statement No. 27(R)

.210 Readers should remain alert to the final issuances and visit the FASB Web site for further information.

Fair Value

.211 During phase one of the FASB's fair value option project, the FASB issued FASB Statement No. 159, which was previously discussed. In phase two of the project, the FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase two are expected to begin in the third quarter of 2007. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.212 In December 2006, the FASB issued an exposure draft titled *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure ended in March 2007, and the FASB has begun redeliberations to consider significant issues raised by respondents. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133, including how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entity's financial position, results of operations, and cash flows. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.213 The FASB is working on a project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, to address issues related to the permitted activities of a qualifying special-purpose entity (QSPE), isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, the FASB issued the exposure draft *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During 2007, the FASB expects to address issues related to the permitted activities of a QSPE and then issue another exposure draft during the fourth quarter of 2007 containing potential amendments to FASB Statement No. 140. See the FASB Web site for complete information.

Earnings Per Share

.214 The FASB and IASB have been working together to resolve differences between FASB Statement No. 128, *Earnings per Share*, and IAS Statement No. 33, *Earnings per Share*. This project is part of the larger FASB project, Short-term International Convergence, which has resulted in the issuance of a number of FASB Statements. Currently the FASB and IASB are addressing significant differences that remain relating to instruments that can be settled in cash or shares and are classified as a liability on an entity's balance sheet. The FASB and IASB are considering modifications to the treasury stock method and several scoping issues in which either the FASB or IASB has issued or may issue more detailed implementation guidance on earnings per share that may create a convergence difference. The FASB and IASB are expected to issue an exposure draft for public comment during the third quarter of 2007. This exposure draft will be the third exposure draft the FASB has issued on the earnings per share project. The project and current exposure draft can be reviewed on the FASB Web site.

FASB Codification and Retrieval Project

.215 The goal of this FASB project is to create a single, authoritative codification of U.S. GAAP. The codification will integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, EITF, and the SEC). The codification will have a three layered structure: topic, subtopic, and section. The FASB has structured the topics into three primary areas: overall presentation, transactional (or financial statement account), and industry. The overall presentation area addresses presentation of financial information but does not address items such as recognition, measurement, or derecognition. The transactional or financial statement account area addresses accounting recognition, measurement, or derecognition. The industry area includes guidance unique to the industry. A codification draft is expected in 2007 and will have an extended verification period to ensure that it accurately reflects U.S. GAAP. Once the FASB addresses respondent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards. Readers can track progress of the Codification and Retrieval Project on the FASB Web site at www.fasb.org/project/codification&retrieval_project.shtml.

GAAP Hierarchy

.216 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, which is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonissuers" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.217 ***Proposed FASB EITF Issues.*** Numerous open issues are under deliberation by the EITF. Proposed EITF issues that are closely related to the securities industry are listed in summary form. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

EITF Issue No. 07-1, Accounting for Collaborative Arrangements

.218 EITF Issue No. 07-1 seeks to determine what type of arrangement constitutes a collaborative arrangement subject to these rules, how costs incurred and revenues generated on sales to third parties should be reported in the case of joint agreements, how sharing payments made to, or received by, a partner pursuant to a Collaboration Agreement should be presented in the Income Statement and what disclosures should be required by the parties to the arrangement. The text is available at www.fasb.org/eitf/0701DA.pdf.

.219 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Proposed FSPs that are closely related to the securities industry are listed in summary form. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

FSP APB 14-a

.220 This proposed FSP would clarify that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of Accounting Principles Board (APB) Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants.* It would require that instruments within its scope be separated into their liability and equity components at initial recognition, and provides guidance on the attribution of proceeds at initial recognition and at settlement. Please see the full text of FSP APB 14-a at www.fasb.org/fasb_staff_positions/prop_fsp_apb14-a.pdf.

FSP FAS 140-d

.221 This proposed FSP states that a transfer of a financial asset and a repurchase agreement involving the transferred financial asset should be considered part of the same arrangement in situations where the counterparties to the two transactions are the same unless certain criteria are met. This FSP focuses on the circumstances that would permit the transferor and transferee to separately evaluate the accounting for a transfer of a financial asset and a repurchase financing under FASB Statement No. 140, *Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* Please see the full text of FSP FAS 140-d at www.fasb.org/fasb_staff_positions/prop_fsp_fas140-d.pdf.

SEC Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards

.222 The SEC published a release to obtain information about the public's interest in allowing U.S. issuers, including investment companies subject to the Investment Company Act of 1940, to prepare financial statements in accordance with International Financial Reporting Standards as published by the International Accounting Standards Board. See Release No. 34-56217 for complete information.

Internal Control Pipeline

COSO Internal Control—Integrated Framework, Guidance on Monitoring Internal Control Systems

.223 COSO released a discussion document, *Guidance on Monitoring Internal Control Systems*, in September 2007 as part of their monitoring project. The document is intended to improve the understanding of the building blocks of effective monitoring, thereby improving both the efficiency and effectiveness of the entire system of internal control. The discussion document can be accessed online at www.coso.org/Publications/COSO_Monitoring_discussiondoc.pdf.

Resource Central

.224 The following are various resources that practitioners engaged in the securities industry may find beneficial.

Publications

.225 Practitioners may find the following publications useful with respect to the securities industry:

- Audit and Accounting Guide *Brokers and Dealers in Securities* (2007) (product no. 012707kk)
- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2007) (product no. 012517kk)
- Audit Guide *Audit Sampling* (2007) (product no. 012537kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2007) (product no. 012777kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- Audit Risk Alert *Independence and Ethics Alert—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.226 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, TPAs, 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.

Continuing Professional Education

.227 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191 [DVD]). 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.
- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

.228 Among the many courses, the following are specifically related to the securities industry:

- *Implementing SOX 404: An Advanced Analysis* (product no. 737177kk). Provides information on understanding the requirements and how to effectively implement the provisions of SOX 404.
- *Management's Assessment of Internal Control* (product no. 181428kk). Based on hard-earned lessons leaned by companies that already have had to comply, this course will take management of both large and smaller public companies through the requirements of each major phase of the internal control assessment project.

.229 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.230 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to the securities industry include modules related to varying aspects of internal controls, PCAOB rules and regulations, and SEC reporting.

.231 To register or learn more, visit www.cpa2biz.com.

Industry Conference

.232 Co-sponsored by the AICPA and the Financial Management Division of the SIFMA, The National Conference on the Securities Industry is designed to update attendees on significant accounting, legal, financial, and tax developments affecting the securities industry. This two-day conference is held in late fall. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

Webcasts

.233 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.234 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.235 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.236 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.237 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. You can reach the Technical Hotline at (877) 242-7212.

Ethics Hotline

.238 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.

AICPA CAQ

.239 The CAQ (formerly the Center for Public Company Audit Firms) was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.240 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit www.thecaq.aicpa.org.

AICPA Industry Expert Panel—Stockbrokerage and Investment Banking Expert Panel

.241 For information about the activities of the Stockbrokerage and Investment Banking Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_stockbroker_investbank.htm.

Industry Web Sites

.242 The Internet covers a vast amount of information that may be valuable to auditors of securities entities, including current industry trends and developments. Some of the more relevant sites for auditors with securities clients include those shown in the following table.

Organization	*Web Site*
Commodity Futures Trading Commission (CFTC)	www.cftc.gov
Financial Crimes Enforcement Network (FinCEN)	www.fincen.gov/
Financial Industry Regulatory Authority (FINRA)	www.finra.org/
Futures Industry Association	www.futuresindustry.org/
National Futures Association	www.nfa.futures.org/
New York Stock Exchange, Inc. (NYSE)	www.nyse.com
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Securities and Exchange Commission (SEC)	www.sec.gov
Securities Industry and Financial Markets Association (SIFMA)	www.sifma.org/

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.243 This Audit Risk Alert replaces *Securities Industry Developments—2006/07*.

.244 The Audit Risk Alert *Securities Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's 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 appreciated. You may e-mail these comments to sreed@aicpa.org or write to:

Susan M. Reed, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

.245

Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org

[*The next page is 8375.*]

AAM Section 8120

Not-for-Profit Organizations Industry Developments—2008

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of not-for-profit organizations with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

Christopher Cole, CPA, CFE
Technical Manager
Accounting and Auditing Publications

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your not-for-profit organization audits. This alert can also be used by an organization's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory 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 financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The not-for-profit industry may be subject to specific risks of material misstatement arising from the nature of its activities, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the organization's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the organization's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the organization's activities is also dynamic, and the organization's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the organization and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the organization's financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.2 percent in 2007, compared with an increase of 2.9 percent in 2006. According to 2007 fourth-quarter final estimates, real GDP increased at an annual rate of just 0.6 percent, down from third quarter real GDP growth of 4.9 percent.

.11 The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. As of February 2008, the unemployment rate was 4.8 percent, representing approximately 7.4 million people.

.12 The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007 when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates a total of 3.00 percentage points to 2.25 percent as of the end of March 2008. The Federal Reserve noted in its March press release that financial markets continue to experience considerable stress and credit continues to tighten for some businesses and households. The housing contraction continues to deepen and labor markets soften. As such, the policy actions taken to decrease rates are meant to promote moderate growth over time and mitigate risks to economic activity while moderating inflation.

The State of Not-for-Profits

.13 The not-for-profit sector is a growth industry. According to a study by the National Center for Charitable Statistics at the Urban Institute that covered the period from 1996 to 2006, the total number of not-for-profits recognized by the IRS increased by 36 percent. Contributions to these organizations in 2006 exceeded $295 billion while total revenues in the sector approached $1.6 trillion and assets held topped $4.3 trillion. According to U.S. Department of Labor (DOL) statistics, 27 percent of the population, or 61 million people in the United States, did volunteer work for not-for-profit organizations. As of January 1, 2007, there were 1.5 million not-for-profit organizations registered with the IRS.

.14 The Philanthropic Giving Index (PGI), established by The Center on Philanthropy at Indiana University, measures trends and expectations in United States charitable giving. The index showed a 1.5 percent increase during 2007, which indicates that the overall climate remained stable during that period.

.15 Not-for-profit organizations continue to face challenges, including continuing demands for accountability from the public and the legislative community. The ongoing demands for accountability have led to the voluntary implementation of Sarbanes-Oxley or similar regulations by some not-for-profit organizations and further discussion of future expansion of those or similar regulations to not-for-profits.

.16 The U.S. economy has shown signs of decline during the first quarter of 2008 and auditors should continue to monitor the impact of economic trends on audit risk throughout the year. The auditor should be aware of regional conditions as well as national conditions when establishing expectations for financial results. This is especially true for the not-for-profit sector in that 70 percent to 80 percent of charitable contributions are for local causes. The health of the local labor market can also have a substantial impact on donations.

Governance and Accountability

.17 Since 2002, when the Sarbanes-Oxley law was enacted, a number of accounting fraud cases have come to light. Many attribute the increase to improved detection as a result of the stringent internal control testing requirements and other provisions of the law, such as whistle-blower hotlines. While the whistle-blower and document retention provisions currently apply to both publicly held companies and not-for-profits, discussion about expanding other provisions of the law to include not-for-profit organizations has occurred. Some not-for-profit organizations have voluntarily adopted some of the provisions of Sarbanes-Oxley, including formation of an audit committee and CFO and CEO certification of the financial statements, either as a result of expectations from their corporate board members or in an effort to improve governance and accountability practices.

.18 Grant Thorton recently issued a survey, conducted in 2007, of 603 top level representatives of religious, social and human services, cultural, and healthcare organizations; educational institutions; and trade and professional associations in 47 states and the District of Columbia. According to the survey, 87 percent of not-for-profit organizations that participated in the survey have made changes to their policies with the goal of improving governance and accountability. The policies that the majority are rewriting or establishing include conflict of interest, investment, code of ethics, records-retention, whistleblower, gift acceptance, review of tax filings, and new board member policies. Nearly two-thirds of those surveyed have also developed an accounting policies and procedures manual, established an audit committee to oversee the financial statement audit and monitor internal controls, and included a CPA on their governing board or audit committee.

Corporate Sponsors

.19 Corporate giving declined by almost 7.0 percent in 2006, although it represents only 4.3 percent of the total giving for a total of $13 billion. However, in-kind giving continues to increase. More than one-third of corporate giving is in-kind. In some circumstances, resources received from corporations are advertising or sponsorship arrangements rather than straightforward monetary contributions and often strings are attached to the transfer. Specifically, the corporation may require goods or services in exchange for those funds, such as naming rights, discounted access to services, and advertisement of the company, among others. Because these transactions may be considered exchange transactions, contributions, or both, not-for-profits must be sure that the transactions are properly recorded in their books.

Embedded Giving

.20 Embedded giving, which builds a gift to a not-for-profit organization into an ordinary consumer purchase, has become a fast growing fundraising practice and an area that is drawing some attention from the U.S. Senate. Although this practice is effective at raising funds on behalf of charities, there are issues regarding accountability for those funds. Not-for-profit organizations may not be aware that money is being solicited in their name. In addition, they may not know what portion of the collected funds to which they are entitled or when they will receive the funds. Consumers may find it difficult to determine whether the money is going to the designated not-for-profit organization. A bill, S. 2529, was introduced in December 2007 in the U.S. Senate to improve disclosures for charitable giving, protect not-for-profit organizations, and inform consumers. The full text of this bill can be found at http://thomas.loc.gov/cgi-bin/query/z?c110:S.2529:.

Funding Administrative Costs

.21 Foundations, corporations, and individuals may have different priorities when it comes to selecting a not-for-profit organization to support. Some may consider the organization's mission, its reputation, the number of people served, or even who else supports it. One factor that frequently receives significant consideration is the percentage of each dollar that is spent on programs. Many donors have the perception that the biggest impact they can make with their contribution is by supporting only programmatic activities. Accordingly, operating expenses such as the accounting department, maintenance and utilities, and the executive management staff often must be supported by unrestricted dollars. Some organizations follow policies for cost allocations, charges, assessments, or assignments that result in some amount of program restricted contributions used for operating expenses. Organizations and their auditors should be careful to understand the administrative allocation process, and whether overhead costs can be paid for with restricted contributions. In addition, some not-for-profit organizations are more frequently requesting funding for organizational administration either as a component of or in addition to their requests for program funding. Auditors should develop a full understanding of the terms of these agreements, including whether they result in restrictions on the use of the funds.

Changing Face of Donors

.22 There has been an increase in the desire for control and "a say in" the direction of the mission of organizations by young donors. Though no statistics are available, a general belief is that the younger affluent donors want to participate as donors and volunteers to the organizations they support more than their older counterparts. They are more likely to want elements of control as conditions of their gifts. Anonymous giving is also increasing. A study conducted by Indiana University reveals that anonymous gifts greater than $5 million increased from 13 gifts in 2005 to 27 gifts in 2006 and 37 gifts in 2007. Possible reasons for the increase are safety concerns of the donors, adherence to religious principles, a desire to avoid solicitations from other organizations, and avoidance of family conflicts. Issues of donor privacy may present unusual problems for auditors as they attempt to confirm the amount and terms of these substantial gifts.

Retiring Work Force

.23 The demographic shift in the workplace, as baby boomers near retirement, is affecting the not-for-profit sector. Surveys indicate that 50 percent to 70 percent of executive directors plan to leave within 5 years. Many are founders and leaders, closely identified with their organizations.

.24 As the sector already suffers from fragile infrastructures, the transitions are expected to be hugely disruptive. Many organizations devote resources to programmatic functions, and do not have executives in training to replace these positions. Succession planning is not seen as a priority.

.25 Auditors may want to consider how the retirement of a key employee, such as the executive director, will affect the organization's internal control procedures and its ability to generate revenues and how the organization will address these issues when they arise.

Cyber Donations

.26 The Internet has become the quick and easy means of providing and accessing information. It has also become a tool to expand the audience of not-for-profit organizations in a way that appeals to younger and more technologically savvy donors. As you surf the net you will find Web sites for thousands of not-for-profits and on most of them will be the opportunity to contribute. Many of these organizations make use of services such as PayPal to permit donors to charge online donations to credit or debit cards. The money is then placed in an account similar to a bank account in the organization's name and a fee is deducted. At some future time the money is then electronically transferred to another bank account as specified by the not-for-profit organization. This may be an area that auditors find worthy of attention in that the not-for-profit organization's internal controls that are required for these accounts may be different from those for deposit accounts at brick and mortar banks. For example, the organization may have controls regarding who is authorized to sign checks but does the organization have controls in place to safeguard usernames and passwords for accounts that allow transactions to be initiated through the Internet. One recent twist on both online and embedded giving is the advent of charity gift cards. The recipient of the gift card goes to the card's Web site and designates which of the listed charities is to receive the donations. Some sites charge an administrative fee at the time of purchase, others when the card is redeemed.

Ethics Rules Overhaul

.27 Lawmakers cannot accept gifts from groups that employ lobbyists. Currently, it is still unclear whether certain not-for-profit organizations are considered to be groups that employ lobbyists pursuant to these new rules. This has led to confusion around charitable events, as lawmakers and charities are unclear whether hand-outs provided by not-for-profit organizations such as meals, gift bags, or free of charge spousal attendance at events violates these rules.

The Independent Sector

.28 In October 2007, the Panel on the Nonprofit Sector, convened by the Independent Sector, released a document titled *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations*.

.29 Convened in October 2004, at the encouragement of the leaders of the Senate Finance Committee, the Panel on the Nonprofit Sector is an independent group of not-for-profit leaders who recommend actions to strengthen the governance, ethical conduct, and accountability of charitable organizations. The panel's members represent a wide range of the not-for-profit community, such as organizations large and small; charities, foundations, and corporate giving programs; and organizations that operate worldwide or in a single community.

.30 The stated purpose of the panel is to preserve the soundness and integrity of the not-for-profit community by striking a careful balance between prudent legal mandates to ensure that organizations do not abuse the privilege of their exempt status and well-informed self-governance and mutual awareness among not-for-profit organizations.

.31 Not-for-profit organizations have long embraced the need for standards of ethical practice that preserve and strengthen the public's confidence. Many such systems in fact already exist, though none have applied to the entire range of American charitable organizations. The guide outlines 33 practices designed to support board members and staff leaders of every charitable organization as they work to improve their own operations. The 33 principles are organized under 4 main categories:

- Legal Compliance and Public Disclosure
- Effective Governance
- Strong Financial Oversight
- Responsible Fundraising

.32 The panel strongly recommends that an organization's board conduct a thorough discussion of the complete set of principles, and determine how the organization should apply each to its operations. It is possible that after this review, a board may conclude certain principles do not apply to its organization. Developing a transparent process for communicating how the organization has addressed the principles, including the reasons that any of the principles are not relevant, is likely to foster a greater appreciation of the diverse nature of the sector and deeper respect for the board's good stewardship.

.33 The complete guide can be accessed at www.nonprofitpanel.org/report/principles/Principles_Guide.pdf.

Legislative and Regulatory Developments

Results of Federal Study on Single Audit Quality

.34 The long-awaited federal study on the quality of audits performed under Office of Management and Budget (OMB) Circular A-133 was issued on June 22, 2007. This section presents a background of the study, a summary of findings, a listing of some deficiencies noted, and the report recommendations. The section also highlights the AICPA and its Governmental Audit Quality Center's (GAQC) next steps to responding to the report.

Background

.35 Several years ago, a group of federal Offices of Inspectors General (OIGs), along with three state auditor's offices, decided to work together to develop a statistically based measure of single audit quality (the project). The U.S. Department of Education served as the project leader. The project had two primary goals:

- Determine the quality of single audits and establish a statistically based measure of audit quality
- Recommend changes in single audit requirements, standards, and procedures to improve the quality of single audits

.36 To accomplish these goals, the OIGs conducted quality control reviews (QCRs) of a statistical sample of 208 audits randomly selected from approximately 38,000 audits submitted to and accepted by the Federal Audit Clearinghouse (FAC) between April 1, 2003 and March 31, 2004. Generally, the audits reviewed were from the 2002–2003 timeframe and, in some cases, earlier. The sample was split into two strata. Stratum I included audits of entities with $50 million or more of total federal expenditures. Stratum II included audits of entities with at least $500,000 but less than $50 million of total federal expenditures.

.37 The scope of the project covered portions of the single audit relating to the planning, conduct, and reporting of audit work related to the review and testing of internal controls and compliance testing pertaining to compliance requirements for selected major federal programs. Documentation of audit work for up to three major programs for each audit was reviewed. Further, the review included audit work performed on the Schedule of Expenditure of Federal Awards (SEFA) and the content of all of the auditors' reports on the federal programs. The scope did not include a review of the content of, or the audit work performed, related to the general-purpose financial statements, the auditor's opinion on those statements, or the auditors' review of internal control over financial reporting.

Summary of Findings

.38 The issues and deficiencies identified in each QCR were compiled, and each engagement was then classified into one of three groupings. The groupings are defined as follows:

- **Acceptable.** No deficiencies were noted, or one or two insignificant deficiencies were noted. In some cases, the acceptable audits had deficiencies with applicable auditing criteria noted, which did not require corrective action, but should be corrected going forward.
- **Limited reliability.** Significant deficiencies with applicable auditing criteria were noted and require corrective action to afford unquestioned reliance upon the entire audit.
- **Unacceptable.** Deficiencies were so serious that the auditor's opinion on at least one major program cannot be relied upon, or a material reporting error was noted requiring that the report be reissued in order to be relied upon by users, or both.

.39 The President's Council on Integrity and Efficiency (PCIE) report clearly shows that improvements are needed in many areas. The tables shown below summarize the overall results and results by stratum. In addition to providing results by the number of audits reviewed, the OIGs also analyzed the results in relation to the dollar amounts of federal awards reported in the audits reviewed. Results in relation to dollar amounts reported in the audits reviewed show a much higher percentage of acceptability. The following tables show the results for both strata combined and then the results of Stratum I and Stratum II individually.[1]

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[1] The report indicates the confidence parameter was 90 percent, and the precision parameters ranged between plus or minus 2.1 and 7.9 percentage points.

TOTAL SAMPLE (STRATA I & II)				
	Acceptable	*Limited Reliability*	*Unacceptable*	*Total*
Sampled Audits	115	30	63	208
Percent of Audits	49%	16%	35%	100%
Percent of Federal Dollars	93%	2%	5%	100%
STRATUM I (>$50 Million in Federal Expenditures)				
	Acceptable	*Limited Reliability*	*Unacceptable*	*Total*
Sampled Audits	61	12	23	96
Percent of Audits	64%	12%	24%	100%
Percent of Federal Dollars	93%	2%	5%	100%
STRATUM II ($500 Thousand–$50 Million in Federal Expenditures)				
	Acceptable	*Limited Reliability*	*Unacceptable*	*Total*
Sampled Audits	54	18	40	112
Percent of Audits	48%	16%	36%	100%
Percent of Federal Dollars	56%	10%	34%	100%

Deficiencies Identified

.40 The PCIE report goes into detail regarding the deficiencies noted on the audits reviewed. The following presents a brief summary of deficiencies identified:

- Misreporting of audit coverage of major federal programs
- Unreported audit findings
- Compliance testing not documented as performed or not applicable
- Deficiencies in understanding and testing of internal control over compliance
- Deficiencies in risk assessments as part of major program determination
- Missing audit finding information
- Deficiencies in presentation and auditing of the SEFA
- Management representations related to federal awards missing or misdated
- Consideration of audit materiality at the major federal program level not documented
- Other kinds of deficiencies (described in appendix A of the report)

PCIE Report Recommendations

.41 The PCIE report proposes a three-pronged approach for reducing the deficiencies noted and to improve the quality of single audits. The recommendations in the report are directed to various organizations, including the OMB and other federal agencies, the AICPA, and other single audit stakeholders. A summary of the recommendations is as follows:

- Revise and improve single audit criteria, standards, and guidance to address deficiencies noted in the report. Specific recommendations are described throughout Part II and the "Other Matters" sections of the PCIE report and include recommendations for revisions to Circular A-133 and, in some cases, additions or clarifications to AICPA auditing standards and the AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits*.
- Establish minimum requirements for completing comprehensive single audit training as a prerequisite for conducting such audits (the report suggests at least 16–24 hours) and thereafter, require single audit update training for continued performance of single audits.
- Review and enhance processes to address unacceptable audits and not meeting established training and continuing professional education requirements. This includes (*a*) reviewing the process of suspension and debarment; (*b*) identifying ways that the AICPA and State Boards of Accountancy can further the quality of single audits and address due professional care issues; and (*c*) identifying, reviewing, and evaluating the potential effectiveness of other ways to address unacceptable audits (these other ways could include sanctions to be applied to auditors or fines, or both).

Next Steps

.42 The AICPA shares the commitment of the federal agencies involved in the project to improving the quality of single audits. Many of the audits reviewed were performed 4–5 years ago, and the AICPA is hopeful that many endeavors over the last several years (for example, the launch of the GAQC) have already begun to address some of the issues raised in the PCIE report.

.43 However, auditors should take this report very seriously and read the PCIE report in its entirety to determine if the audit quality deficiencies cited in the report may affect the planning of your future engagements or your current audit methodologies and documentation practices.

.44 The AICPA and the GAQC Executive Committee and GAQC staff will be working closely with the federal government on a go-forward basis to address the PCIE report recommendations. During the course of the next year, auditors should watch the GAQC Web site at www.aicpa.org/GAQC for updates on initiatives undertaken by the AICPA and others in response to the PCIE report.

Help Desk—To access the PCIE report go to the following Web site: www.ignet.gov/pande/audit/NatSamProjRptFINAL2.pdf.

Government Auditing Standards Developments

.45 In July 2007, the U.S. Government Accountability Office (GAO) issued the July 2007 revision to *Government Auditing Standards* (Yellow Book or GAO Report No. GAO-07-731G). The July 2007 revision supersedes the 2003 revision and updates the January 2007 revision. The July 2007 revision contains the final 2007 revisions, including the quality control and peer review sections in chapter 3, which the GAO had exposed for comment in January 2007. The July 2007 revision represents the completed 2007 revision of *Government Auditing Standards* and is the version that should be used until further revisions or updates are made. It will be effective for financial audits and attestation engagements for periods beginning on or after January 1, 2008 and for performance audits beginning on or after January 1, 2008. Early implementation is encouraged. A downloadable version of the complete July 2007 revision is available on the GAO's Yellow Book Web page at www.gao.gov/govaud/ybk01.htm. You will also find ordering information for the printed version on the GAO's Yellow Book Web page.

.46 The GAO has also issued a summary document titled *Major Changes: July 2007 Revision to* Government Auditing Standards on its Web site at www.gao.gov/govaud/somc0707.pdf. This document highlights key revisions to the standards including those specifically related to ethics and independence, professional judgment and competence, all types of audits and attestation engagements performed under the Yellow Book, and financial and performance audits. The listing of changes is intended to assist practitioners in updating their related policies and procedures for conducting government audits.

IRS Activities

E-Postcard Required for Small Exempt Organizations

.47 Beginning in 2008, exempt organizations with gross receipts under $25,000 must make an annual electronic filing with the IRS using Form 990-N, *Electronic Notification (e-Postcard) For Tax-Exempt Organizations Not Required to File Form 990 or 990–EZ*. The e-Postcard is due in 2008 for tax years beginning on or after December 31, 2006. If an organization that is required to file fails to do so for three consecutive years, it will lose its tax exempt status. For more information and a link to the e-Postcard go to www.irs.gov/charities/article/0,,id=169250,00.html.

Form 990 Redesigned for Tax Year 2008

.48 In December 2007, the IRS issued an updated version of Form 990 for tax year 2008 (which will be filed in 2009). The stated goals of the IRS in redesigning Form 990 are enhancing transparency, promoting tax compliance, and minimizing the burden on the filing organization. The basic structure of the new form consists of an 11 page core form, which is to be completed by all filers, and 16 schedules designed by topic (lobbying, related parties, compensation, and so on). There is a transition period for smaller organizations, which may allow them to use Form 990-EZ and for certain schedules pertaining to hospitals and tax-exempt bonds. There have also been substantial changes to the amount and type of information that is required on the new Form 990. Some of the more significant changes include the following:

- More questions regarding organizational governance practices
- Disclosure of information from the organization's audited financial statements
- Expansion of compensation information disclosures
- Expansion of disclosures regarding programs and activities of the organization

.49 The IRS issued preliminary instructions and a glossary for use with Form 990 in April 2008. More information, including drafts of the form and schedules, is available at www.irs.gov/charities/article/0,,id=176613,00.html.

Department of Treasury and IRS Issue Priority Guidance Plan for 2008

.50 Fiscal year 2008 priorities are addressed through a flexible and interdisciplinary array of new tools to focus on enforcement of the tax law and to improve customer service. Priorities include the following:

- Implementing a voluntary compliance program for delinquent filers
- Addressing the issue of donor control and noncash contributions
- Continuing a variety of compliance projects that focus on areas such as political activity, executive compensation, community foundations, and colleges and universities
- Implementing Tax Exempt Determination System (TEDS) to improve processing of exempt organization applications
- Developing a new compliance guide, a *cyber assistant*, and formal guidance on hot topics such as Form 990 revisions

.51 Additional information on these and other topics is available at www.irs.gov/pub/irs-tege/fy08_implementing_guidelines.pdf.

Exempt Organization Abusive Tax Avoidance Transactions

.52 Tax-exempt organizations, by definition, are exempt from federal income tax under various provisions of the Internal Revenue Code (IRC). However, some are directly involved in Abusive Tax Avoidance Transactions (ATATs). In addition, because they are tax-indifferent, tax-exempt organizations are, at times, used by for-profit entities as accommodation parties in these transactions. Identifying and responding to ATATs involving tax-exempt organizations is critical to the IRS objective of discouraging and deterring noncompliance within tax-exempt and government entities.

.53 As a result of provisions included in the Tax Increase Prevention and Reconciliation Act (TIPRA) of 2005, the Treasury Department and IRS have issued proposed and temporary regulations under IRC Section 4965, which imposes excise taxes and disclosure requirements with respect to prohibited tax shelter transactions to which tax-exempt entities are parties. The new regulations provide (1) rules regarding the form, manner, and timing of disclosure obligations and (2) return requirements accompanying payment of excise taxes. The deadline for submitting comments on the proposed regulations has passed. IRS guidance addresses the following issues under this legislation:

- Which entities and individuals are subject to excise tax under the new provisions and which taxes and penalties may apply
- Who is a party subject to the new provisions, and the treatment of proceeds of transactions received before the effective date of the new provisions
- Disclosure and filing requirements

.54 Additional information is available at www.irs.gov/charities/article/0,,id=172158,00.html.

Certain Charitable Contributions Designated as Transactions of Interest Under New Reportable Transaction Regulations

.55 In September 2007, the IRS issued Notice 2007-72, designating certain transactions as having the potential for tax avoidance or evasion and alerting participants to required disclosures and potential penalties. In the transactions, a taxpayer transfers a membership interest in a limited liability company that directly or indirectly owns real property to a Section 501(c)(3) charitable organization or government entity, claiming a charitable contribution deduction for an amount significantly higher than the original purchase price paid by the taxpayer to acquire the interest. Charitable organizations that receive property in these transactions after August 14, 2007 are participants in these transactions for the first year in which their tax returns reflect the acquired interest, which is generally the year of receipt of the interest. For that year, the charity must disclose certain information to the IRS required by the reportable transaction regulations or be subject to penalties as described in the notice. The IRS has begun notifying organizations that have participated in these transactions that they have been selected for examination.

Prohibition Against Political Activities

.56 The prohibition against political campaign activity has been in effect for more than half a century and bars certain tax-exempt organizations from engaging on behalf of or in opposition to political candidates. However, these organizations can engage in advocating for or against issues and, to a limited extent, ballot initiatives or other legislative activities.

.57 "The political contests, especially for president, are starting earlier than usual. The IRS, as it has in the past, wants to remind charities and churches of the ban on political campaign activity. We also want to urge nonprofit and religious organizations to review the guidance we have issued to help them avoid any problems," said Steven T. Miller, Commissioner of IRS Tax Exempt and Government Entities Division.

.58 The IRS's goal is to educate the leadership of these organizations to help them stay within the legal boundaries. In this regard, IRS Revenue Ruling 2007-41 outlines a number of scenarios to help charities and churches understand the ban on political campaign activity and actions that may arise.

.59 In addition to the revenue ruling, the IRS has other helpful information for churches and charities on its Web site at www.irs.gov/eo. For example, IRS Publication 1828, "Tax Guide for Churches and Religious Organizations," contains a discussion of the law affecting political campaign activity by churches and religious institutions.

.60 Violation of the law can result in imposition of an excise tax or, in extreme cases, a loss of tax exempt status.

.61 In June 2007, the IRS released its report on the Political Activity Compliance Initiative (PACI) for the 2006 election cycle. This report, *PACI 2006*, follows the report on prohibited political campaign intervention in the 2004 election cycle, which was issued in February 2006.

Employment Taxes and Classifying Workers

.62 In December 2007, the IRS issued Fact Sheet (FS) 2007-27 to help organizations better understand their responsibilities regarding employment taxes and classifying workers. To access this guidance, which provides criteria to better understand the regulations, go to www.irs.gov/newsroom/article/0,,id=177092,00.html.

.63 Additionally, in November 2007, FS 2007-25 was issued, which outlines the IRS initiative regarding compliance with employer tax regulations. This initiative includes both IRS and various state workforce agencies that will work together and exchange information to improve taxpayer compliance in this complicated area.

Internet-Based Workshop for Exempt Organizations

.64 The IRS has a Web based version of its popular Exempt Organizations Workshop covering tax compliance issues confronted by small and mid-sized tax exempt organizations.

.65 The free online workshop, *Stay Exempt—Tax Basics for 501(c)(3)s*, consists of five interactive modules on tax compliance topics for exempt organizations:

- *Tax-Exempt Status*—How can you keep your 501(c)(3) exempt?
- *Unrelated Business Income*—Does your organization generate taxable income?
- *Employment Issues*—How should you treat your workers for tax purposes?
- *Form 990*—Would you like to file an error-free return?
- *Required Disclosures*—To whom do you have to show your records?

.66 Users can access this new training program at www.stayexempt.org. Users can complete the modules in any order and repeat them as many times as they like. The online training Web site does not require registration and its visitors will remain anonymous.

Resource Materials—Compliance Initiatives for Tax-Exempt Organizations

.67 The Exempt Organization Division of the IRS has made materials available that were used in or which discuss its compliance initiatives including LLC projects, community foundations, bond compliance, hospitals, and executive compensation. You can find this material at www.irs.gov/charities/article/0,,id=162493,00.html.

Listing of Published Guidance—2008

.68 Readers should be aware that the IRS Web site contains a digest of exempt organizations' published guidance issued in 2008 at www.irs.gov/charities/content/0,,id=177153,00.html. The published guidance includes treasury regulations, revenue rulings, revenue procedures and notices, and announcements of recently published issues of interest to tax-exempt organizations.

.69 Additionally, the IRS Web site also contains an archive that presents digests of IRS published guidance items of interest to tax-exempt organizations. The archived guidance can be found at www.irs.gov/charities/article/0,,id=151053,00.html.

Tax Preparer Penalties

.70 In December 2007, the IRS issued Notice 2008-13, which implements a May 2007 law that expanded the tax return preparer penalty and heightened the standards of conduct that must be met by tax return preparers in order to avoid a penalty.

.71 For undisclosed positions on a tax return, the new law replaced the *realistic possibility standard* with a requirement that there be a reasonable belief that the tax treatment of the position would more likely than not be sustained on its merits. In cases in which the taxpayer discloses the position on the tax return, the notice implements the new law that states there must be a reasonable basis for the tax treatment of the position taken on the tax return.

.72 The notice provides interim rules to implement and interpret these heightened standards. The interim rules will be in effect until the overhaul of the current return preparer penalty regulations is complete. The interim rules emphasize the importance to preparers of understanding the legal basis for positions taken on tax returns, the requirement for taxpayers to disclose certain positions, and the need for preparers to advise taxpayers on the various penalties that can apply when a position is taken on a return that may not be supported by existing law.

.73 Under the notice, preparers generally can continue to rely on taxpayer representations in preparing returns and can also generally rely on representations of third parties, unless the preparer has reason to know they are wrong.

.74 The new law also expanded the return preparer penalty to cover all tax return preparers, not just income tax return preparers. Under the notice, preparers of many information returns, however, will not be subject to the new penalty provision unless they willfully understate tax or act in reckless or intentional disregard of the law. The notice also includes examples illustrating how the new standards would apply.

.75 Notice 2008-13 also solicits input from the tax return preparer community on a planned overhaul of the tax return preparer penalty regime anticipated to be completed by the end of 2008. The notice can be found at www.irs.gov/pub/irs-drop/n-08-13.pdf.

.76 In addition to Notice 2008-13, additional guidance has been provided in Notice 2008-12 with respect to the implementation of the tax return preparer signature requirement, and in Notice 2008-11, which clarifies the transition relief provided in Notice 2007-54, issued earlier this year.

Uniform Prudent Management of Institutional Funds Act

.77 In February 2008, the Financial Accounting Standards Board (FASB) released for public comment proposed FASB Staff Position (FSP) FAS 117-a, *Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act*, *and Enhanced Disclosures*. If approved as proposed, the FSP would

- provide guidance on the net asset classification of donor-restricted endowment funds for not-for-profit organizations that are subject to an enacted version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA). (As of February 1, 2008, 13 states and the District of Columbia had enacted a version of UPMIFA, with legislation pending in several other states.)
- improve disclosures about an organization's endowment funds (both donor-restricted and funds functioning as endowment), whether or not the organization is subject to UPMIFA.

.78 The FSP would be effective for fiscal years ending after June 15, 2008, with earlier application permitted.

.79 The first, and perhaps most significant question the proposed FSP addresses is how UPMIFA's elimination of the historic-dollar-value threshold—the amount below which an organization could not spend under the Uniform Management of Institutional Funds Act (UMIFA)—affects net asset classification. The proposed FSP would require an organization to classify a portion of a donor-restricted endowment fund (other than a term endowment) as permanently restricted net assets. That portion would be equal to the amount of the fund (*a*) that must be retained permanently in accordance with explicit donor stipulations, or (*b*) that in the absence of such stipulations, the organization's governing board determines must be retained permanently, if any, under the relevant law. The organization would be required to disclose its interpretation of the law. We anticipate that discussions among organizations, accountants, attorneys, and regulators in the various individual states may lead to consensus in those states determining what must be retained permanently under the law. If a governing board determines that the law requires maintenance of purchasing power of a donor's gift, the organization would increase permanently restricted net assets to the extent that the purchasing power of a dollar decreases or decrease permanently restricted net assets to the extent that the purchasing power of a dollar increases. (This would typically be done by adjusting permanently restricted net assets by an appropriate inflationary factor, such as the consumer price index [CPI] or higher education price index [HEPI].)

.80 In contrast, an organization would not subsequently decrease permanently restricted net assets because of investment losses or organizational spending from the endowment, but would instead decrease temporarily restricted net assets, if available, or unrestricted net assets. The guidance on investment losses and spending is consistent with the guidance previously provided on investment losses in FASB Statement No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, paragraph 12. FASB considered but decided not to change that guidance, noting that permanently restricted net assets should reflect the amount for which an organization has a permanent fiduciary duty and not the amount that it has on hand at a financial statement date because of cumulative investment and spending decisions.

.81 The proposed FSP also addresses whether two other provisions in UPMIFA's endowment spending guidelines impose temporary (time) restrictions on the portion of a donor-restricted endowment fund that would otherwise be considered unrestricted net assets:

- A provision that "[u]nless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution"
- An optional provision for a rebuttable presumption that spending more than 7 percent of endowment market value is imprudent (Some states have included this provision, while others have not.)

.82 The FSP would require organizations to apply the guidance previously provided in Emerging Issues Task Force (EITF) Topic No. D-49, "Classifying Net Appreciation on Investments of a Donor-Restricted Endowment Fund," included as an appendix to the FSP. EITF Topic No. D-49 stresses that not all legal restrictions on the use of particular assets result in restricted net assets for accounting purposes, only those that extend donor restrictions. An example of the latter would be a requirement to maintain the purchasing power of a donor's endowment gift. Laws that refer to actions entirely within the purview of a governing board, such as acting to appropriate funds or exercising prudence do not, in and of themselves, extend donor imposed restrictions. The FSP contains the important caveat that, in applying the guidance in EITF Topic

No. D-49, an organization would need to look at the actual wording in the specific version of UPMIFA (and other relevant law) to which the organization is subject.

.83 The other key provisions of the proposed FSP focus on improving endowment disclosures, both donor restricted and board designated. Aiming to improve transparency about endowments in an era of increased public scrutiny, the proposed FSP focuses on disclosures in four areas:

- Net asset classification (especially how that is affected by a governing board's interpretation of relevant law)
- Spending policies
- Investment policies (especially their relationship with spending policies)
- Net asset composition and changes therein (especially the relationship of endowment spending to endowment size and growth)

.84 Auditors should look for a final FSP in June 2008.

New Filing and Audit Requirements for ERISA-Covered 403(b) Employee Benefit Plans

.85 Beginning in 2009, employee benefit plans sponsored by charitable organizations and schools under IRC Section 403(b) and covered under the Employee Retirement Income Security Act (ERISA) will be subject to the same reporting and audit requirements that currently exist for Section 401(k) plans. Section 403(b) plans are also commonly known as *tax-shelter annuity plans*. Under new U.S. DOL regulations issued in November 2007 amending the filing requirements for Form 5500, *Annual Return/Report of Employee Benefit Plan*, ERISA-covered 403(b) plans with 100 or more participants generally will be required to file audited financial statements beginning with their 2009 Form 5500 filing. 403(b) plans with fewer than 100 participants will be eligible to use abbreviated reporting forms without audited financial statements. The DOL estimates that approximately 7,000 403(b) plans will be subject to the new audit requirements and another 9,000 403(b) plans will be eligible for the waiver. The DOL regulations were published in the November 16, 2007 *Federal Register* and are available at www.dol.gov/ebsa/regs/fedreg/final/20071116.pdf. The AICPA's Employee Benefit Plan Audit Quality Center (EBPAQC) (www.aicpa.org/EBPAQC) and Expert Panel have formed a joint task force to develop resources to help members with these new audit requirements.

Other Regulatory Activities

.86 Listed below are links to documents of interest for not-for-profit organizations not discussed elsewhere in this alert. Readers should continue to monitor all activity involving the not-for-profit sector:

- *U.S. Department of the Treasury Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities* at www.ustreas.gov/offices/enforcement/key-issues/protecting/charities-intro.shtml. This link also contains the Treasury's response to comments submitted on the original guidelines. The Treasury has also issued a risk matrix to further assist in understanding and implementing these guidelines. The matrix can be found at www.ustreas.gov/offices/enforcement/ofac/policy/charity_risk_matrix.pdf.
- Political Activity and Disclosure Requirements (March 2006) Congressional Research Library Report RL-33377 at www.ncseonline.org/NLE/CRSreports/06May/RL33377.pdf.
- *Tax Relief and Health Care Act of 2006* (December 20, 2006) at www.thomas.gov/cgi-bin/query/z?c109:H.R.6111.ENR:, which contains provisions regarding the tax-exempt status of charitable remainder trusts in relation to unrelated business taxable income.
- IRS Charitable Rollover Clarification by the IRS (January 2007) Notice 2007-05 www.irs.gov/irb/2007-05_IRB/ar11.html. There is also guidance on other provisions of the *Pension Protection Act of 2006*.

- The *Honest Leadership and Open Government Act of 2007* (September 2007) requires disclosures related to lobbying and earmarks. The full text of the bill can be found at www.thomas.gov/cgi-bin/bdquery/z?d110:s.00001:.

Audit and Attestation Issues and Developments

Guidance on Alternative Investments, Such as Hedge Funds and Investments Related to Subprime Loans

.87 Over the past several years, certain not-for-profit organizations, healthcare entities, pension plans, and investment companies—including some hedge funds and funds of funds—have dramatically increased their investment in financial instruments that do not have a readily determinable market value. These investments are commonly referred to as alternative investments. Many entities report alternative investments at fair value; developing valuations, as well as obtaining sufficient appropriate audit evidence in support of the valuation assertion, can present challenges because of the lack of readily determinable fair value and the limited investment information generally provided by the fund managers. For example, the value of investments related to subprime loans (which may be either direct holdings of subprime loans or ownership of entities or investment vehicles, such as tranches, whose value is affected by the value of subprime loans) have reportedly declined significantly based on recent developments, including but not limited to decreased liquidity for such investments. However, the existence of investments related to subprime loans within an alternative investment portfolio and the basis for their valuation may not be obvious.

.88 To address the auditing challenges associated with all alternative investments, the Alternative Investments Task Force developed and issued a practice aid for auditors in 2006, *Alternative Investments—Audit Considerations*. The practice aid clarifies the responsibility of the client to have appropriate controls in place in order for management to adequately address valuation assertions and for the auditor to obtain comfort over the valuation of investments. Specifically, the practice aid includes guidance on the following:

- General considerations pertaining to auditing alternative investments
- Addressing management's financial statement existence assertion
- Addressing management's financial statement valuation assertion
- Management representations
- Disclosure of certain significant risks and uncertainties
- Reporting

.89 The practice aid also includes appendixes on confirmations for alternative investments and illustrative examples of due diligence, ongoing monitoring, and financial reporting controls.

.90 Download the document from: www.aicpa.org/members/div/auditstd/alternative_investments.htm.

.91 Many of the elements of the practice aid may assist auditors in addressing the audit issues related to recent market developments including subprime related matters.

.92 In addition, auditors should consider AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), to determine the appropriate period in which to recognize any identified declines in value. Due to current market conditions, even the financial statements of organizations that do not hold alternative investments may suffer significant declines that merit application of the guidance in AU section 560.

Bond Insurance Company Issues

.93 The current credit environment has affected the market for debt securities. For example, several entities that insure tax exempt debt have been downgraded by rating agencies and some investors have avoided certain debt securities. While each situation is different and should be evaluated based on its own specific facts and circumstances, the current situation may raise various accounting and auditing issues pertaining to tax exempt debt, including, but not limited to, the following:

- Bond restructurings
- Derivative and hedge accounting implications
- Potential violation of debt covenants
- Classification of the debt on the balance sheet as either a current or noncurrent liability
- Subsequent event disclosures
- Going concern issues

.94 At the time this alert went to press, an ad hoc AICPA task force was drafting a nonauthoritative article to address these issues in more detail. When completed, that article will be posted at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_notforprofit.htm.

Summary of Recent Auditing and Attestation Pronouncements and Related Guidance

.95 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard supersedes SAS No. 61, *Communication With Audit Committees*. The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards*, to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on*

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Recent Auditing and Attestation Pronouncements and Related Guidance	
(Applicable to audits conducted in accordance with GAAS)	*Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120). • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks. • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report.* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report.
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	See the "AICPA Risk Assessment Standards" section in this alert.
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325 par. .01–.04), of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.
Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330 par. .01–.06), of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
Statement of Position (SOP) 07-2, *Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisors, or Other Service Providers* (AICPA, *Technical Practice Aids*, AUD sec. 14,430) Issue Date: October 2007 (Interpretive publication)	This statement addresses the application of SSAEs primarily to examination engagements in which a practitioner reports on the suitability of the design and operating effectiveness of a service provider's controls in achieving specified compliance control objectives. Examples of the service providers addressed by this SOP are investment advisers, custodians, transfer agents, administrators, and principal underwriters that provide services to investment companies, investment advisers, or other service providers.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditors report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This practice aid is a response to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.
AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This practice aid provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditor's report.

The Auditor's Communication With Those Charged With Governance

.96 In December 2006, the Auditing Standards Board (ASB) issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees*. This SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and became effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to entities that either have an audit committee or have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.97 SAS No. 114 provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires that significant matters communicated with those charged with governance be documented.

Identifying Those Charged With Governance

.98 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the organization and obligations related to the accountability of the organization, including overseeing the organization's financial reporting process. The SAS uses the term *management* to refer to those 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.

.99 The auditor should determine the appropriate person(s) within the organization's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by organization, reflecting influences such as size and ownership characteristics.

.100 Because there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the organization's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the organization's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.101 The ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which became effective for audits of financial statements for periods ending on or after December 15, 2006. SAS No. 112 establishes standards and provides guidance on communicating matters related to an organization's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. This SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion). Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued, the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. However, with the adoption of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), the PCAOB redefined these terms, which now differ from SAS No. 112.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.
- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, and identifies indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.
- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This also includes significant

deficiencies and material weaknesses that were communicated in previous audits if they have not been remediated.

- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.
- Contains illustrative written communications to management and those charged with governance.

Discussions With Management and Others

.102 The requirements of SAS No. 112 have changed perceptions regarding the auditor's role in the client's internal control in some circumstances. Auditors may have to continue to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm, other than the auditor, that does not provide attest services for the client can be part of a client's internal control. This may continue to raise questions regarding the role of outsourcing in achieving management's internal control objectives.

.103 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of material weaknesses. Another reason is that auditors have to include in written communication significant deficiencies and material weaknesses that were identified and communicated in previous years, for as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.104 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented or detected and corrected, by the client.

Issues for Audits of Smaller Entities

.105 An issue that has caused concern is the extent to which the auditor may be involved in the drafting of an organization's financial statements. It is a strong indication of material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, or detecting and correcting, material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, because doing so would impair independence.[2] How an auditor responds to a client's internal control weakness, in terms of designing and

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[2] See Ethics Ruling 101-3, "Performance of nonattest services," of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05).

carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditors response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.106 The requirements of SAS No. 112 will continue to introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing.

.107 The AICPA published Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

AICPA Risk Assessment Standards

.108 The 8 SASs referred to as the risk assessment standards (SAS Nos. 104–111) became effective for audits of financial statements for periods beginning on or after December 15, 2006, (earlier application was permitted), which means they are effective for 2007 calendar year audits. Although the SASs include many of the underlying concepts and detailed performance requirements contained in the standards they amend or supersede, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risks of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between the risks, controls, audit procedures, and conclusions.

Key Provisions of the Risk Assessment Standards

.109 The following tables list the key provisions of the eight risk assessment standards and provide summaries of how these standards differ from previous AICPA generally accepted auditing standards (GAAS).

SAS No. 104, Amendment to Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures* ("Due Professional Care in the Performance of Work")

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 104 defines *reasonable assurance* as a "high level of assurance."	• SAS No. 104 clarifies the meaning of reasonable assurance.

SAS No. 105, Amendment to Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 105 expands the scope of the understanding that the auditor must obtain in the second standard of field work from "internal control" to "the entity and its environment, including its internal control."	• Previous guidance considered the understanding of the entity to be a part of audit planning, and emphasized that the understanding of internal control also was primarily part of audit planning.

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Key Provisions	*How the SAS Differs From Current Standards*
• Previous guidance considered the understanding of the entity to be a part of audit planning, and emphasized that the understanding of internal control also was primarily part of audit planning.	• By stating that the purpose of your understanding of the entity and its internal control is part of assessing the risk of material misstatement, SAS No. 105 essentially considers this understanding to provide audit evidence that ultimately supports your opinion on the financial statements. • The new standard emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures. It is anticipated that "generic" audit programs will not be an appropriate response for all engagements because risks vary between entities. • The term *further audit procedures*, which consists of test of controls and substantive tests, replaces the term *tests to be performed* in recognition that risk assessment procedures are also performed. • The term *audit evidence* replaces the term *evidential matter*.

SAS No. 106, Audit Evidence

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 106 defines *audit evidence* as "all the information used by the auditor in arriving at the conclusions on which the audit opinion is based."	• Previous guidance did not define audit evidence. • SAS No. 106 also describes basic concepts of audit evidence. • The term *sufficient, appropriate audit evidence*, defined in SAS No. 106, replaces the term *sufficient, competent evidence.*
• SAS No. 106 recategorizes assertions by classes of transactions, account balances, and presentation and disclosure; expands the guidance related to presentation and disclosure; and describes how the auditor uses relevant assertions to assess risk and design audit procedures.	• SAS No. 106 recategorizes assertions to add clarity. • *Assertion relating to presentation and disclosure* has been expanded and includes a new assertion that information in disclosures should be "expressed clearly" (understandability).
• SAS No. 106 defines *relevant assertions* as those assertions that have a meaningful bearing on whether the account is fairly stated.	• The term *relevant assertions* is new, and it is used repeatedly throughout SAS No. 106.
• SAS No. 106 provides additional guidance on the reliability of various kinds of audit evidence.	• The previous standard included a discussion of the competence of evidential matter and how different types of audit evidence may provide more or less valid evidence. SAS No. 106 expands on this guidance.

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 106 identifies *risk assessment procedures* as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement at the financial statement and relevant assertion levels. • SAS No. 106 provides that evidence obtained by performing risk assessment procedures, as well as that obtained by performing tests of controls and substantive procedures, is part of the evidence the auditor obtains to draw reasonable conclusions on which to base the audit opinion, although such evidence is not sufficient in and of itself to support the audit opinion.	• SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risk of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately support the auditor's opinion on the financial statements.
• SAS No. 106 describes the types of audit procedures that the auditor may use alone or in combination as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor.	• Risk assessment procedures include — inquiries of management and others within the entity. — analytical procedures. — observation and inspection.
• SAS No. 106 includes guidance on the uses and limitations of inquiry as an audit procedure.	• Inquiry alone is not sufficient to evaluate the design of internal control and to determine whether it has been implemented.

SAS No. 107, Audit Risk and Materiality in Conducting an Audit

Key Provisions	*How the SAS Differs From Current Standards*
• The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of 1. determining the extent and nature of risk assessment procedures. 2. identifying and assessing the risk of material misstatement. 3. determining the nature, timing, and extent of further audit procedures. 4. evaluating whether the financial statements taken as a whole are presented fairly, in conformity with generally accepted accounting principles.	• Previous guidance said that auditors "should consider" audit risk and materiality for certain specified purposes. SASs state that the auditor "must" consider. • New guidance explicitly states that audit risk and materiality are used to identify and assess the risk of material misstatement.

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Key Provisions	*How the SAS Differs From Current Standards*
• Combined assessment of inherent and control *risks* is termed the *risk of material misstatement*.	• SAS No. 107 consistently uses the term *risks of material misstatement*, which often is described as a combined assessment of inherent and control risk. However, auditors may make separate assessment of inherent risk and control risks.
• The auditor should assess the risk of material misstatement as a basis for further audit procedures. Although that risk assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. • Assessed risks and the basis for those assessments should be documented.	• SAS No. 107 states that the auditor should have and document an appropriate basis for the audit approach. • These two provisions of the risk assessment standards effectively eliminate the ability of the auditor to assess control risk "at the maximum" without having a basis for that assessment. In other words, you can no longer "default" to maximum control risk.
• The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management.	• SAS No. 107 provides additional guidance on communicating misstatements to management. • The concept of not accumulating misstatements below a certain threshold is included in the previous standards, but SAS No. 107 provides additional, specific guidance on how to determine this threshold.
• The auditor should request management to respond appropriately when misstatements (known or likely) are identified during the audit.	• SAS No. 107 provides specific guidance regarding the appropriate auditor's responses to the types of misstatements (known or likely) identified by the auditor.

SAS No. 108, Planning and Supervision

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 108 provides guidance on — appointment of the independent auditor. — establishing an understanding with the client. — preliminary engagement activities. — the overall audit strategy. — the audit plan. — determining the extent of involvement of professionals possessing specialized skills.	• Much of the guidance provided in SAS No. 108 has been consolidated from several existing standards. • However, SAS No. 108 provides new guidance on preliminary engagement activities, including the development of an overall audit strategy and an audit plan. — The overall audit strategy is what previously was commonly referred to as the audit approach. It is a broad approach to how the audit will be conducted, considering factors such as the scope of the engagement, deadlines for performing the audit and issuing the report, and recent financial reporting developments.

Key Provisions	*How the SAS Differs From Current Standards*
— using a professional possessing IT skills to understand the effect of IT on the audit. — additional considerations in initial audit engagements. — supervision of assistants.	— The audit plan is more detailed than the audit strategy and is commonly referred to as the audit program. The audit plan describes in detail the nature, timing, and extent of risk assessment and further audit procedures you perform in an audit. • SAS No. 108 states that you should obtain a written understanding with your client.

SAS No. 109, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 109 describes audit procedures that the auditor should perform to obtain the understanding of the entity and its environment, including its internal control.	• The auditor should perform *risk assessment procedures* to gather information and gain an understanding of the entity and its environment. These procedures include inquiries, observation, inspection, and analytical procedures. Previous standards did not describe the procedures that should be performed to gain an understanding of the client. • Information about the entity may be provided by a variety of sources, including knowledge about the entity gathered in previous audits (provided certain conditions are met), and the results of client acceptance and continuance procedures. • SAS No. 109 also directs the auditor to perform a variety of risk assessment procedures, and it describes the limitations of inquiry.
• The audit team should discuss the susceptibility of the entity's financial statements to material misstatement.	• Previous standards did not require a "brainstorming" session to discuss the risk of material misstatements. SAS No. 109 requires such a brainstorming session, which is similar (and may be performed together with) the brainstorming session to discuss fraud.
• The purpose of obtaining an understanding of the entity and its environment, including its internal control, is to identify and assess "the risk of material misstatement" and design and perform further audit procedures responsive to the assessed risk.	• SAS No. 109 directly links the understanding of the entity and its internal control with the assessment of risk and design of further audit procedures. Thus, the understanding of the entity and its environment, including its internal control, provides the audit evidence necessary to support the auditor's assessment of risk.
• SAS No. 109 states the auditor should assess the risk of material misstatement at both the financial statement and relevant assertion levels.	• The previous standard included the concept of assessing risk at the financial statement level, but SAS No. 109 provides expanded and more explicit guidance. • SAS No. 109 also directs the auditor to determine how risks at the financial statement level may result in risks at the assertion level.

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Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 109 provides directions on how to evaluate the design of the entity's controls and determine whether the controls are adequate and have been implemented.	• Under the previous standard, the primary purpose of gaining an understanding of internal control was to plan the audit. Under SAS No. 109, your understanding of internal control is used to assess risks. Thus, the understanding of internal control provides audit evidence that ultimately supports the auditor's opinion on the financial statements. • The previous standard directs the auditor to obtain an understanding of internal control as part of obtaining an understanding of the entity and its environment. SAS No. 109 requires auditors to evaluate the design of controls and determine whether they been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. It is anticipated that this phase of the audit will require more work than simply gaining understanding of internal control.
• SAS No. 109 directs the auditor to consider whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.	• Previous standard did not include the concept of "significant risks." • Significant risks exist on most engagements. • The auditor should gain an understanding of internal control and also perform substantive procedures for all identified significant risks. Substantive analytical procedures alone are not sufficient to test significant risks.
• SAS No. 109 provides extensive guidance on the matters that should be documented.	• The guidance provided by SAS No. 109 relating to documentation is significantly greater than that provided by previous standards.

SAS No. 110, Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 110 provides guidance on determining overall responses to address the risk of material misstatement at the financial statement level and the nature of those responses.	• The concept of addressing the risk of material misstatement at the financial statement level and developing an appropriate overall response is similar to the requirement in previous standards relating to the consideration of audit risk at the financial statement level. However, that guidance was placed in the context of audit planning. SAS No. 110 "repositions" your consideration of risk at the financial statement level so you make this assessment as a result of and in conjunction

Key Provisions	*How the SAS Differs From Current Standards*
	with your performance of risk assessment procedures. In some cases, this assessment may not be able to be made during audit planning. • SAS No. 110 requires you to consider how your assessment of risks at the financial statement level affect individual financial statement assertions, so that you may design and perform tailored further audit procedures (substantive tests or tests of controls). • The list of possible overall responses to the risk of material misstatement at the financial statement level also has been expanded.
• Further audit procedures, which may include tests of controls, or substantive procedures should be responsive to the assessed risk of material misstatement at the relevant assertion level.	• Although the previous standards included the concept that audit procedures should be responsive to assessed risks, this idea was embedded in the discussion of the audit risk model. The SASs repeatedly emphasize the need to provide a clear linkage between the auditor's understanding of the entity, the auditor's risk assessments, and the design of further audit procedures. • SAS No. 110 requires you to document the linkage between assessed risks and further audit procedures, which was not a requirement under the previous standards.
• SAS No. 110 provides guidance on matters the auditor should consider in determining the nature, timing, and extent of such audit procedures.	• The new guidance on determining the nature, timing, and extent of tests of controls and substantive tests has been expanded greatly and addresses issues that previously were not included in the authoritative literature. • SAS No. 110 states that the nature of further audit procedures is of most importance in responding to your assessed risk of material misstatement. That is, increasing the extent of your audit procedures will not compensate for procedures that do not address the specifically identified risks of misstatement. • SAS No. 110 states that you should perform certain substantive procedures on all engagements. These procedures include: — performing substantive tests for all relevant assertions related to each material class of transactions, account balance, and disclosure regardless of the assessment of the risk of material misstatements.

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Key Provisions	How the SAS Differs From Current Standards
	— agreeing the financial statements, including their accompanying notes, to the underlying accounting records. — examining material journal entries and other adjustments made during the course of preparing the financial statements.

SAS No. 111, Amendment to Statement on Auditing Standards No. 39, *Audit Sampling*

Key Provisions	How the SAS Differs From Current Standards
• SAS No. 111 provides guidance relating to the auditor's judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls.	• SAS No. 111 provides enhanced guidance on tolerable misstatement. In general, tolerable misstatement in an account should be less than materiality to allow for aggregation in final assessment. • SAS No. 111 revises AU section 350, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1), to state that sample sizes determined using either statistical or nonstatistical methods would ordinarily be comparable in size.

.110 Whether due to error or fraud, the risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks that may lead to a material misstatement in the client's financial statements and any mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations of the Treadway Commission's framework at www.coso.org/key.htm). These standards may significantly affect the formality of the auditor's risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs should have already been completed and has likely resulted in significant changes to firm audit methodologies and personnel training.

.111 The AICPA issued Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk), which can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. The AICPA has also issued a number of questions and answers based upon member inquiries in the fall edition of the *In Our Opinion* newsletter. That newsletter can be accessed at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion/.

Companion Audit Guide

.112 In December 2006, the AICPA published Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors further understand the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Audit Documentation Technical Practice Aids

.113 In May 2007, the ASB issued two Technical Practice Aid (TPA) Technical Questions and Answers (TIS) related to SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which was issued in December 2005.

.114 TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.115 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*), discusses whether the provisions of AU section 339 related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. This question and answer indicates that AU section 339 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance*

.116 A key provision of AU section 339 is the amendment to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the organization's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms, an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.117 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date
- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.118 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf.

Accounting Issues and Developments

FASB Accounting Standards Codification™

.119 On January 15, 2008, FASB launched the 1-year verification period of the *FASB Accounting Standards Codification*™ (codification). The codification is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. The codification includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, EITF, and related literature. The codification also includes relevant authoritative content issued by the Securities Exchange Commission (SEC), as well as selected SEC staff interpretations and administrative guidance.

.120 The codification does not change GAAP, but rather it reorganizes thousands of GAAP pronouncements into approximately 90 topics. Therefore, the one-year verification period is not to debate the underlying requirements of GAAP, but rather to verify that the codification appropriately captures them and accurately reflects existing U.S. GAAP for nongovernmental entities. The verification period is also a period for constituents to acquaint themselves with the new structure and submit feedback regarding any issues before the codification content becomes authoritative. At the end of the one-year verification period, FASB is expected to formally approve the codification as the single source of authoritative U.S. accounting and reporting standards, other than guidance issued by the SEC. At that time, FASB will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the codification will become nonauthoritative. FASB expects to approve the codification in April 2009.

.121 The codification uses a topical structure in which topics, subtopics, and sections are numerically referenced. This effectively organizes the content without regard to the original standard-setter or standard from which the content was derived. The topics of the codification reside in four main areas: presentation, financial statement accounts, broad transactions, and industry guidance. The overall presentation area addresses presentation of financial information but does not address items such as recognition, measurement, or derecognition. For example, topics in this area include income statement, balance sheet, and earnings per share. The financial statement account area presents topics in financial statement order including assets, liabilities, equity, revenue, and expenses. The broad transactions area includes topics related to multiple financial statement accounts that are transaction oriented, such as derivatives and business combinations. The industry area includes guidance unique to an industry or type of activity such as airlines, software, and real estate.

.122 Constituents are encouraged to use FASB's online Codification Research System free of charge and provide feedback to FASB on the codification. The Codification Research System includes general information on how to use the online research system and special features such as Cross Reference Reports, which show where current standards reside in the codification. Readers are encouraged to register and access the codification at www.fasb.org/project/codification&retrieval_project.shtml. Special attention should be paid to where the FASB reconciled conflicts in existing GAAP and to identify any unintentional changes to GAAP.

Changes to the Financial Accounting Foundation, FASB, and Governmental Accounting Standards Board

.123 In February 2008, the Board of Trustees of the Financial Accounting Foundation (FAF) voted to approve major changes to the oversight, structure, and operations of the FAF and its two standard-setting boards, FASB and the Governmental Accounting Standards Board (GASB).

.124 Specifically, the FAF Board of Trustees approved the following key changes:

- FAF changes include
  - — expanding the number and breadth of investors, accounting, business, financial, and government organizations and entities invited to nominate FAF trustees with the understanding that the final authority for all appointments rests solely with the discretion of the Board of Trustees;
  - — changing the current term of trustees from one three-year term with a possible second three-year term to one five-year term;
  - — changing the size of the Board of Trustees from a fixed 16 trustees to a flexible range of 14–18 trustees; and
  - — increasing the trustee governance activities, including its level of formal review, analysis and oversight of the data and materials regularly provided by FASB, Financial Accounting Standards Advisory Council (FASAC), GASB, and Governmental Accounting Standards Advisory Council (GASAC).
- FASB changes include
  - — reducing the size of FASB from seven members to five, effective July 1, 2008;
  - — retaining the FASB simple majority voting requirements;
  - — affirming the need for investor participation on FASB by broadening the current bylaw requirement that FASB members possess investment experience; and
  - — changing FASB's agenda-setting process whereby the FASB chair is vested with the authority, following appropriate consultation, to set the FASB project plans, agenda, and priority of projects.
- GASB changes include
  - — securing a stable and permanent funding source for GASB;
  - — retaining the current size, term length, and composition of GASB; and
  - — changing GASB's agenda-setting process whereby the GASB chair is vested with the authority, following appropriate consultation, to set the GASB project plans, agenda, and priority of projects.

Convergence With International Financial Reporting Standards

.125 Since their joint meeting in September 2002, FASB and the International Accounting Standards Board (IASB) have had a common goal—one set of accounting standards for international use. At the 2002 meeting, FASB and the IASB signed "The Norwalk Agreement," a memorandum of understanding between the two rule-setting bodies. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. At that meeting, FASB and the IASB pledged to use their best efforts to make their existing financial reporting standards fully compatible as soon as is practicable and to coordinate their future work programs to ensure that once achieved, compatibility is maintained. At their meetings in April and October 2005, FASB and the IASB reaffirmed their commitment to the convergence of U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS). A common set of high quality, globally accepted standards remains the long-term strategic priority of both FASB and the IASB.

.126 There has been progress toward this goal. FASB Statement No. 157, *Fair Value Measurements*, and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, take U.S. GAAP in the direction of IFRS with respect to reporting at fair value. The goal of FASB and the IASB is to reach a conclusion in 2008 about whether major differences in a few focused areas should be eliminated through one or more short-term standard-setting projects and, if so, complete or substantially complete work in those areas. Those areas include impairment, income taxes, investment properties, government grants, research and development, joint ventures, subsequent events, and segment reporting. For more information on the status of this project go to www.fasb.org and www.iasb.org.

XBRL Initiative

.127 eXtensible Business Reporting Language (XBRL) is an XML-based markup language used to communicate financial and business data electronically. XBRL is being developed by an international not-for-profit consortium with more than 450 member organizations, including accounting firms, software providers, financial intermediaries, academics, and technologists.

.128 XBRL is used to "tag" financial statements so that the information in those statements is machine readable, thereby allowing users to analyze financial information more easily and quickly. To assist with the tagging process, XBRL US has currently developed over 11,000 financial concepts, which essentially represent a dictionary of U.S. GAAP and other financial reporting requirements.

.129 On January 11, 2008, the SEC Advisory Committee on Improvement to Financial Reporting proposed that the SEC adopt a mandatory phase-in of XBRL for a specified time period, starting with the largest 500 domestic public reporting companies. As of the date of this alert, that mandatory phase-in period had not yet been determined. Be sure to check the SEC's Interactive Data link at www.sec.gov to view the current status of the project.

.130 For more information on XBRL, visit the XBRL site at www.xbrl.org.

Summary of Recent Accounting Pronouncements and Related Guidance

.131 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 161 (March 2008)	*Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*
FASB Statement No. 160 (December 2007)	*Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*
FASB Statement No. 141 (revised 2007) (December 2007)	*Business Combinations*
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
FASB Statement No. 158 (September 2006)	*Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*

Recent Accounting Pronouncements and Related Guidance	
FASB Interpretation No. (FIN) 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* FASB Staff Position (FSP) FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, issued in February 2008, defers the effective date of FIN 48 for certain nonpublic enterprises, as defined in the FSP, to the annual financial statements for fiscal years beginning after December 15, 2007.
FASB EITF Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA SOP 07-1 (AICPA, *Technical Practice Aids*, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* In February 2008, FASB issued FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*, which indefinitely defers the effective date of SOP 07-1 and prohibits adoption of the SOP for an entity that has not early adopted the SOP before issuance of this FSP. An entity that early adopted the SOP before issuance of this FSP, is permitted, but not required to continue to apply the provisions of the SOP. Entities that elect to retain their adoption of the guidance must apply it to all consolidated entities going forward, including those formed or acquired after the adoption of SOP 07-1.
TIS section 6140.20–.22 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss not-for-profit organizations fund-raising expenses.
TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various employee benefit plan topics.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.132 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the not-for-profit 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. The AICPA general *Audit Risk Alert—2007/08* and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.

Disclosures About Derivative Instruments and Hedging Activities

.133 In March 2008, FASB issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The new standard is intended to improve financial reporting about derivative instruments and hedging activities by requiring enhanced disclosures to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows.

.134 The new standard improves transparency about the location and amounts of derivative instruments in an entity's financial statements; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*; and how derivative instruments and related hedged items affect its financial position, financial performance, and cash flows.

.135 FASB Statement No. 161 achieves these improvements by requiring disclosure of the fair values of derivative instruments and their gains and losses in a tabular format. It also provides more information about an entity's liquidity by requiring disclosure of derivative features that are credit risk related. Finally, it requires cross referencing within footnotes to enable financial statement users to locate important information about derivative instruments.

.136 It is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged.

Business Combinations

.137 In December 2007, FASB issued FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51,* which establishes accounting and reporting standards for the noncontrolling interest in a subsidiary (sometimes called *minority interests*) and for the deconsolidation of a subsidiary. None of the following apply to not-for-profit organizations: FASB Statement No. 160 nor its amendments to Accounting Research Bulletin (ARB) No. 51; Accounting Principles Board (APB) Opinion Nos. 18 and 29; FASB Statement Nos. 60, 89, 128, 130, and 142; FASB Interpretation Nos. (FINs) 37 and 46(R); AICPA Accounting Interpretation No. 1; Statement of Position (SOP) 04-2, *Accounting for Real Estate Time-Sharing Transactions* (AICPA, *Technical Practice Aids*, ACC sec. 10,910); and several EITF issues. Not-for-profit organizations should continue to apply the guidance in Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, before the amendments made by FASB Statement No. 160, SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations* (AICPA, *Technical Practice Aids*, ACC sec. 10,610), and other applicable standards until FASB issues interpretative guidance. FASB Statement No. 160 is effective for fiscal years beginning on or after December 15, 2006. Earlier adoption is prohibited.

.138 Also in December 2007, FASB issued FASB Statement No. 141 (revised 2007), *Business Combinations*, which replaces FASB Statement No. 141, *Business Combinations.* Like its predecessor, FASB Statement No. 141(R) is not applicable to combinations between not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization. The nullifications or amendments to other standards made by FASB Statement No. 141(R) also are not applicable to not-for-profit organizations. Thus, not-for-profit organizations should continue to apply FASB Statement Nos. 72 and 147 and FINs 4 and 9, as indicated in paragraphs 1.24–.28 of AICPA Audit and Accounting Guide *Not-For-Profit Organizations*. Not-for-profit organizations also should continue to apply the following standards as indicated in paragraphs 1.24–.28 of AICPA Audit and Accounting Guide *Not-For-Profit Organizations* without regard to the amendments made by FASB Statement No. 141(R): ARB No. 43; APB Opinion Nos. 14, 18, 28, 29, and 30; FASB Statement Nos. 2, 5, 15, 45, 52, 60, 68, 86, 87, 97, 106, 109, 113, 120, 123(R), 133, 142, 144, 146, 150, and 154; and FINs 21, 26, 46(R), and 48. In addition, the amendments made by FASB Statement No. 141(R) to FASB Technical Bulletin (TB) 84-1; AICPA Statement of Position Nos. 78-9, 90-7, 93-6, 96-1, 00-3, 01-6, 03-3, and 05-1; and AICPA Practice Bulletin (PB) Nos. 4, 6, and 14 do not apply to not-for-profit organizations, nor do the changes made by FASB Statement No. 141(R) to FASB TB 85-5; FSP Nos. 141-1 and 142-1; AICPA PB No. 11, many EITF issue consensuses, and several responses in the FASB Staff Q&A on FASB Statement No. 109, *Accounting for Income Taxes*.

Fair Value Measurements

FASB Statement No. 157

.139 In September 2006, FASB issued Statement No. 157, *Fair Value Measurements*, to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

.140 Prior to this statement, there were different definitions of fair value, and guidance for applying those definitions was dispersed among many accounting pronouncements. Difference in the existing guidance created inconsistencies that added to the complexity in applying GAAP. FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period.

.141 In February 2008, the FASB issued FSP FAS 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13*, which amends FASB Statement No. 157, to exclude FASB Statement No. 13, *Accounting for Leases*, and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under FASB Statement No. 13. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under FASB Statement No. 141 or FASB Statement No. 141(R), regardless of whether those assets and liabilities are related to leases. This FSP is effective upon the initial adoption of FASB Statement No. 157.

.142 FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. However, in February 2008, FASB also issued FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, which is effective upon issuance. This FSP delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008 and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow the FASB and its constituents the time to consider the various implementation issues associated with FASB Statement No. 157. Readers can access the full text of FASB Statement No. 157 on the FASB Web site at www.fasb.org.

.143 The following paragraphs summarize FASB Statement No. 157, but are not intended as a substitute for the reading of the statement itself.

Definition of Fair Value

.144 Paragraph 5 of FASB Statement No. 157 defines *fair value* as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." That definition retains the exchange price notion in earlier definitions of fair value, but clarifies that the exchange price is the price in a hypothetical transaction at the measurement date in the market in which the reporting entity would transact for the asset or liability. The hypothetical transaction to sell the asset or transfer the liability is considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the definition of fair value focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

.145 A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the *principal market*—defined as the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability—or, in the absence of a principal market, the most advantageous market for the asset or liability.

.146 A fair value measurement of an asset assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. Highest and best use for an asset is established by one of two valuation premises: *value in-use* or *value in-exchange*. The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, value in-use might be appropriate for certain nonfinancial assets. An asset's value in-use should be based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those other assets would be available to market participants. The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, value in-exchange might be appropriate for a financial asset. An asset's value in-exchange is determined based on the price that would be received in a current transaction to sell the asset standalone.

.147 A fair value measurement for a liability reflects its *nonperformance risk* (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its *credit risk* (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value.

Valuation Techniques

.148 As described in FASB Statement No. 157, valuation techniques, which are consistent with the market approach, income approach, cost approach, or some combination of these approaches, should be used to measure fair value:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.
- The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multiperiod excess earnings method.
- The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as *current replacement cost*). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

.149 Valuation techniques that are appropriate in the circumstances and for which sufficient data are available should be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate and the respective indications of fair value should be evaluated and weighted, as appropriate.

Present Value Techniques

.150 Appendix B of FASB Statement No. 157 provides guidance on present value techniques. Present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the *discount rate adjustment technique* (also called the *traditional present value technique*) uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, expected present value techniques use the probability-weighted average of all possible cash flows (referred to as *expected cash flows*). The traditional present value technique and two methods of expected present value techniques are discussed more fully in appendix B of FASB Statement No. 157.

The Fair Value Hierarchy

.151 FASB Statement No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability (referred to in the statement as inputs). Paragraphs 21–31 establish a fair value hierarchy that distinguishes between (*a*) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (*observable inputs*) and (*b*) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (*unobservable inputs*). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs.

.152 The fair value hierarchy in FASB Statement No. 157 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available, except as discussed in paragraphs 25–26 of FASB Statement No. 157.
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Adjustments to Level 2 inputs will vary depending on factors specific to the asset or liability. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a Level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall. Level 2 inputs include the following:
  - — Quoted prices for similar assets or liabilities in active markets
  - — Quoted prices for identical or similar assets or liabilities in markets that are not active
  - — Inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates)
  - — Inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs)
- Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk).

Disclosures

.153 Paragraphs 32–35 of FASB Statement No. 157 expand the disclosures required for assets and liabilities measured at fair value. For assets and liabilities that are measured at fair value on a recurring basis in periods subsequent to initial recognition or that are measured on a nonrecurring basis in periods subsequent to initial recognition, the statement requires the reporting entity to disclose certain information that enables users of its financial statements to assess the inputs used to develop those measurements. For recurring fair value measurements using significant unobservable inputs (Level 3), the reporting entity is required to disclose certain information to help users assess the effect of the measurements on earnings (or changes in net assets) for the period.

FASB Statement No. 159

.154 Subsequent to the issuance of FASB Statement No. 157, FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with FASB's long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an organization to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently, without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.155 FASB Statement No. 159 is effective as of the beginning of an organization's first fiscal year that begins after November 15, 2007. FASB and the SEC expressed concern in the way some early adopters applied the transition provisions of the standard. The AICPA Center for Audit Quality (CAQ) issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard, such as this, is applied in a good faith manner consistent with those objectives and principles. Specifically the alert warns auditors to "be alert for circumstances in which an organization proposes to adopt FASB Statement No. 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

Deferral of FIN 48 for Certain Nonpublic Entities

.156 FIN 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109,* was issued in June 2006 and is effective for fiscal years beginning after December 15, 2006. However, subsequent to its issuance the FASB issued FSP FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, which defers the effective date of FIN 48 for nonpublic enterprises included in the FSP's scope to the annual financial statements for fiscal years beginning after December 15, 2007. For the full text of FIN 48 and its associated FSPs visit the FASB Web site.

Recent AICPA Independence and Ethics Pronouncements

.157 AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

On the Horizon

.158 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the not-for-profit industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.159 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
Financial Accounting Standards Board (FASB)	www.fasb.org
Governmental Accounting Standards Board (GASB)	www.gasb.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Overhaul Project—AICPA Audit and Accounting Guide *Not-For-Profit Organizations*

.160 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Not-For-Profit Organizations*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1996. During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.

Auditing Pipeline—Nonissuers

ASB Clarity Project

.161 The ASB formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB issued a discussion paper titled *Improving the Clarity of ASB Standards,* seeking feedback on proposals to "clarify" its standards. In response to the feedback received on the discussion paper and subsequent discussions with interested parties, the ASB has established clarity drafting conventions and has undertaken to revise all of its SASs in accordance with those conventions. The clarity drafting conventions include:

- Establishing objectives for each of the standards, thereby providing a framework for the application of professional judgment
- Presenting application and other explanatory material in a separate section that follows the requirements
- Numbering application and other explanatory material paragraphs using an "A" prefix
- Cross-referencing introductory, objective, and requirement paragraphs to related application and other explanatory material paragraphs
- Using formatting techniques to enhance the readability of the SASs
- Including, where necessary, special considerations relevant to the audit of smaller, less complex entities within the text of the SAS
- Including, where necessary, any special considerations in the audit of governmental entities within the text of the SAS
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards

Convergence With International Standards

.162 The ASB is working toward convergence with international auditing standards, whereby projects are developed concurrently with those of the International Auditing and Assurance Standards Board (IAASB). The ASB has created a number of task forces charged with monitoring specific activities of the IAASB, assisting the ASB in commenting on exposure drafts of International Standards on Auditing (ISA), and drafting proposed SASs using the ISA, including the international convention for wording, as the base standard. The status of ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.163 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an organization's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, the ASB previously decided to defer the issuance of a final revised AT section 501 until the PCAOB issued its amendments and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www.aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of **Present Fairly in Conformity With Generally Accepted Accounting Principles**

.164 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to FASB's proposed Statement of Financial Accounting Standards *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal places responsibility for the

GAAP hierarchy for nongovernmental entities in the accounting literature. Accordingly, the proposed SAS deletes the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA, *Professional Standards*, vol. 1, AU sec. 411]). The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www.fasb.org. The ASB will issue its final SAS coincidentally with FASB's issuance of its final standards. As noted earlier in this alert, the PCAOB has already adopted its proposal to remove the GAAP hierarchy from its standards.

Accounting Pipeline

.165 Presented below are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year alert have not been finalized as of the date of this writing, and thus are included again.

Fair Value

.166 During phase one of FASB's fair value option project, FASB issued FASB Statement No. 159, which was previously discussed. In phase two of the project, FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase two are expected to begin in the first quarter of 2008. Readers should remain alert to developments by visiting the FASB Web site.

Transfers of Financial Assets

.167 FASB is working on a project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, to address issues related to the permitted activities of a qualifying special-purpose entity (QSPE), isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, FASB issued the exposure draft *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During the second quarter of 2008, FASB expects to issue an amended exposure draft. See the FASB Web site for complete information.

Income Taxes

.168 The objective of this project is to improve the accounting for income taxes and reduce the application differences between FASB Statement No. 109, *Accounting for Income Taxes*, and IAS Statement No. 12, *Income Taxes*. FASB plans to issue an exposure draft during the second quarter of 2008. Readers can track the project's progress on the FASB Web site.

GAAP Hierarchy

.169 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, FASB believes the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, which is responsible for selecting its accounting principles for financial statements. Accordingly, FASB concluded that the GAAP hierarchy should reside in the accounting literature established by FASB. FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonissuers" section) to ensure that each of the statements has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.170 ***Proposed FASB EITF Issues.*** Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.171 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

.172 The following are various resources that practitioners engaged in the not-for-profit industry may find beneficial.

Publications

.173 Practitioners may find the following publications useful with respect to the not-for-profit industry:

- Audit and Accounting Guide *Not-For-Profit Organizations* (2008) (product no. 012648kk)
- Audit Guide Government Auditing Standards *and Circular A-133 Audits* (2007) (product no. 012747kk)
- Audit and Accounting Guide *State and Local Governments* (2008) (product no. 012668kk)
- Audit and Accounting Guide *Health Care Organizations* (2007) (product no. 012617kk)
- Audit Guide *Analytical Procedures* (2008) (product no. 012558kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2008) (product no. 012518kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2008) (product no. 012778kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- Audit Risk Alert *State and Local Governmental Developments—2007* (product no. 022437kk)
- Audit Risk Alert Government Auditing Standards *and Circular A-133 Audits—2007/08* (product no. 022457kk)
- Audit Risk Alert *Health Care Industry Developments—2007/08* (product no. 022348kk)
- Audit Risk Alert *Compilation and Review Alert—2007/08* (product no. 022308kk)
- Audit Risk Alert *Independence and Ethics Alert—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- Financial Reporting Alert *Current Accounting Issues and Risks—2008* (product no. 029208kk)
- *Checklists and Illustrative Financial Statements* for *Not-for-Profit Organizations* (product no. 008988kk)
- *Accounting Trends & Techniques—Not-for-Profit Organizations* (2005) (product no. 006616kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.174 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. 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.

Continuing Professional Education

.175 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191kk [DVD]). 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.
- *Internal Control Deficiencies: Assessment and Reporting Under SAS 112* (product no. 733290kk [text] or 183290kk [DVD]). This course focuses on compliance with the standard's requirement by examining each stage of the decision making framework using numerous illustrations and practice exercises. The course also applies to managers of nonpublic companies to enable them to decide whether a control deficiency exists and how to correct it.

.176 Among the many courses, the following are specifically related to the not-for-profit industry:

- *Auditing Nonprofits: Tips and Traps* (product no. 731524kk [text]). This course will help you better understand essential aspects of auditing in this industry to conduct audits in the most effective manner, and offer practical tips to guide you through possible traps encountered in auditing a not-for-profit.
- *Nonprofit Auditing and Accounting Update (2007–2008 Edition)* (product no. 732093kk [text] or 182074kk [DVD]). Covering all the latest auditing and accounting developments affecting not-for-profit entities, this course will give you a complete understanding of changes in the not-for-profit environment. For 2007–2008, the course will include coverage of the new Yellow Book, the risk assessment SASs, SAS No. 112, and more.
- *Accounting and Reporting Practices of Not-for-Profit Organizations* (product no. 743275kk [text]). Understand and apply the requirements of FASB and AICPA pronouncements to your not-for-profit clients. Consider real-world financial statements, cases and problems faced by CPAs with not-for-profit clients and by executives of not-for-profit organizations.
- *Frequent Frauds Found in Governments and Not-For-Profits* (product no. 733310kk [text]). Through an informative case study approach, this course illustrates common frauds that make headlines and damage the reputations of government and not-for-profit organizations.

.177 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.178 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com.

Webcasts

.179 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.180 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

Member Service Center

.181 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.182 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9am to 8pm on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

.183 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.

Industry Conference

.184 The AICPA offers its annual not-for-profit conference in June. The National Not-For-Profit Industry Conference is a comprehensive forum that deals with the challenges facing not-for-profit practitioners and financial executives today. It's where you'll find out the latest information on the impact of tax, management, auditing, and accounting issues pertaining to not-for-profit organizations. You'll also receive training in operational strategies that are crucial to the well-being of a not-for-profit organization. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA Governmental Audit Quality Center

.185 The GAQC is a firm-based voluntary membership Center designed to help CPAs meet the challenges of performing quality audits in this unique and complex area. The GAQC's primary purpose is to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The GAQC also offers resources to enhance the quality of a firm's governmental audits.

.186 The mission of the GAQC is to do the following:

- Raise awareness about the importance of governmental audits.
- Serve as a comprehensive resource provider on governmental audits for member firms.
- Create a community of firms that demonstrates a commitment to governmental audit quality.
- Provide center members with an online forum tool for sharing best practices and discussing audit, accounting, and regulatory issues.
- List member firms to enable purchasers of governmental audit services to identify firms that are members.
- Provide information about the center's activities to other governmental audit stakeholders.

.187 For more information about the GAQC, visit http://gaqc.aicpa.org.

AICPA Industry Expert Panel—Not-for-Profit Organizations

.188 For information about the activities of the AICPA's Not-for-Profit Organizations Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_notforprofit.htm.

Industry Web Sites

.189 The Internet covers a vast amount of information that may be valuable to auditors of not-for-profit organizations, including current industry trends and developments. Some of the more relevant sites for auditors with not-for-profit clients include those shown in the appendix of this alert.

.190 The Not-for-Profit industry practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

* * * *

.191 This Audit Risk Alert replaces *Not-for-Profit Organizations Industry Developments—2007*.

.192 The Audit Risk Alert *Not-for-Profit Organizations Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to ccole@aicpa.org or write to

Christopher Cole, CPA, CFE
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

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Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues guides, practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee (PCFRC)	Information on the initiative to further improve FASB's standard-setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org

Web Site Name	*Content*	*Web Site*
Board Source	Resources to help strengthen not-for-profit organization boards of directors	www.boardsource.org
The Chronicle of Philanthropy	Articles from the Chronicle of Philanthropy 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.compasspoint.org
CPAnet	Links to other Web sites of interest to CPAs	www.cpanet.com
Guidestar	Information on not-for-profit organizations and news and resources for not-for-profit organizations and donors	www.guidestar.org
Independent Sector	A forum to encourage giving, volunteering, not-for-profit initiatives, and citizen action	www.independentsector.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/charities/index.html
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	www.nccs.urban.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 Nonprofit Times newspaper and links to other sites	www.nptimes.com
U.S. Office of Management and Budget	OMB information and literature	www.whitehouse.gov/OMB

[*The next page is 8461.*]

AAM Section 8130

High-Technology Industry Developments—2007/08

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of high-technology entities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

Zachary T. Donahue, CPA
Senior Technical Manager
Accounting and Auditing Publications

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your high-technology entity audits. This alert can also be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory 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 financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The high-technology industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic, and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the entity's financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.2 percent in 2007, compared with an increase of 2.9 percent in 2006. According to 2007 fourth-quarter advance estimates, real GDP increased at an annual rate of just 0.6 percent, down from third quarter real GDP growth of 4.9 percent.

.11 The unemployment rate remained relatively unchanged during 2007, holding between 4.4 percent and 5.0 percent, with an annual average rate of 4.6 percent. As of January 2008, the unemployment rate was 4.9 percent, representing approximately 7.6 million people.

.12 The target for the federal funds rate remained stable at 5.25 percent from June 2006 to September 2007 when the Federal Reserve began decreasing rates. Since the first rate decrease in September 2007, the Federal Reserve has decreased rates a total of 2.25 percent to 3.00 percent as of the end of January 2008. The Federal Reserve noted in its January press release that financial markets continue to experience considerable stress, and credit continues to tighten for some businesses and households. The housing contraction continues to deepen and labor markets soften. As such, the policy actions taken to decrease rates are meant to promote moderate growth over time and mitigate risks to economic activity while moderating inflation.

Industry Trends and Conditions

.13 Worldwide IT spending is expected to continue to increase in 2008. Gartner Inc. predicts that 2008 spending will grow 5.5 percent to $3.3 trillion. A Harris poll performed in July and October 2007 revealed that 80 percent of Americans now go online, spending an average of 11 hours per week on the Internet. Thus, IT continues to increasingly become a part of more Americans' daily way of life.

.14 According to a September 2007 Forrester Research Inc. report, 2007 investment and purchases data show a modest revival in growth after the slowdown in the second half of 2006. With Department of Commerce data revisions lowering IT investment levels in 2006, the technology industry is expected to build on the moderate second quarter 2007 growth in the fourth quarter of 2007, with growth rates approaching 8 percent. Software continues to lead the industry, with nearly an 8 percent growth rate. Computer equipment investment is starting to improve, but communications equipment investment is decreasing.

.15 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-technology industry is made up of 45 Standard Industrial Classification codes. These sectors fall into three broad categories, namely, high-technology manufacturing, communications services, and software and computer-related services.

.16 Because the high-technology industry is not easily defined, its definition 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, namely, personal computers (PC); semiconductors; mainframes, servers, and storage; networking and telecommunications equipment; and software and services.

Personal Computers

.17 According to Gartner Inc. preliminary results, worldwide PC shipments totaled 271.2 million units in 2007, a 13.4 percent increase over 2006. The industry ended 2007 with fourth quarter PC shipments of 75.9 million units, a 13.1 percent increase over fourth quarter 2006. Worldwide PC shipments were projected to total 257.1 million units in 2007; however, actual shipments exceeded projection by over 5 percent.

.18 The Europe, Middle East, and Africa (EMEA) region continued to be the largest PC market in 2007 with PC shipments of 92 million during the year, a 14.7 percent increase over 2006. Asia and South Pacific took over as the second largest market during the fourth quarter of 2007. PC shipments totaled 70.7 million in the Asia and South Pacific region during 2007, an 18 percent increase over 2006. The U.S. PC market grew 5.3 percent in 2007 with PC shipments of 64.2 million. These results characterize well the worldwide PC market landscape: continued strong growth in emerging regions and slower growth in markets such as the United States.

.19 PC shipments are expected to grow by 11 percent in 2008, although recent turmoil in global financial markets may cause the growth rate to be lower. Much of the growth in emerging markets is being driven by new users of PCs and not replacement purchases. While PC manufacturers have found growth opportunities in emerging markets, they face increasing challenges for new sales in established markets, including weak desktop PC replacement and narrowing penetration opportunities. Mobile PC shipments continue to be one of the PC market's primary drivers of growth, whereas desktop PC sales were weaker in some regions. Forrester Research Inc.'s 2007 worldwide PC adoption forecast predicts more than 1 billion PC units will be in use by the end of 2008, and over 2 billion by 2015, which would reflect more than 12 percent annual growth from 2003 to 2015.

Semiconductors

.20 Worldwide semiconductor revenue totaled $270.3 billion in 2007, a 2.9 percent increase from 2006, according to preliminary results by Gartner Inc. Strong performance had been expected for 2007, largely due to a strong demand for electronic equipment and stabilization in the chip average selling prices (ASP). However, according to the Semiconductor Industry Association (SIA), sharp declines in ASP in some segments—microprocessors, dynamic random access memory (DRAM), and NAND flash—will contribute to slower growth in worldwide sales than had been expected. Price declines in some segments, such as DRAM, are a result of oversupply. According to SIA, worldwide sales are expected to hit $252 billion in 2007 and $306 billion in 2010. The SIA revised its projection in 2007 to project 5.4 percent compound annual growth for year-end 2006 through 2010. Price competition is a major contributor to price eroding more quickly than had been historically noted.

.21 As the semiconductor industry attempts to remedy its oversupply in the memory market, which led to sharp ASP declines, worldwide semiconductor equipment spending is forecast to decrease 9.9 percent in 2008 to $40.3 billion, according to Gartner Inc. All major segments of the capital equipment market are projected for negative spending in 2008, including a weak first half of the year for DRAM spending as DRAM companies slow their capital investments to help correct the supply and demand situation.

Mainframes, Servers, and Storage

.22 Worldwide server shipments for the third quarter of 2007 (the latest available data) grew 8.7 percent over the third quarter of 2006, according to Gartner Inc. Worldwide server revenue totaled $13.4 billion for the third quarter of 2007, and server shipments totaled over 2.2 million units. According to Gartner Inc., the blade server segment continued to drive the growth in the third quarter of 2007. Worldwide blade server shipments grew 13.8 percent, which was 10 percent of the overall server shipments. The server blade market increased for the fourth consecutive quarter, including factory revenue growing at 41.4 percent year over year. Also, blade servers passed the $1.0 billion revenue mark for the first time ever in one quarter.

.23 According to International Data Corporation's (IDC) Worldwide Quarterly Server Tracker, although the third quarter of 2007 was the sixth consecutive quarter of positive revenue growth and the highest third quarter server revenue since 2000, it was the slowest growth rate since the first quarter of 2006. The most significant growth area is in volume systems, with revenue growth of 8.1 percent year over year in the third quarter of 2007, which is the second highest growth rate over the past 8 quarters. Despite growth in Windows, Linux, and Unix servers, revenue for midrange enterprise servers declined 2.2 percent year over year, which marks the second consecutive quarterly decrease for that segment. High-end enterprise server revenue decreased 14.5 percent year over year, which is the largest decline in over 5 years. According to IDC, we are in the early stages of a market-wide transition, which will require significant IT investment in a more flexible IT fabric, although concern about an economic slowdown could slow investment into new systems.

.24 Worldwide external controller-based disk storage revenue totaled $3.9 billion in the third quarter of 2007, a 3.4 percent increase over the third quarter of 2006 according to Gartner Inc. The Asia and South Pacific region increased its revenue by 22.7 percent year over year. This growth is distributed primarily among India, Australia, Taiwan, and China. As the cost of media storage continues to drop, there will likely be a focus on hidden or indirect costs of storage. Some of the indirect costs result from the rapidly increasing volume of data being stored, as well as new legal challenges and higher insurance costs to ensure these data are properly kept and not damaged or lost. The growing demand for such services is an opportunity for high-technology companies.

Networking and Telecommunications Equipment

.25 Demand for mobile phones in emerging markets such as the Middle East, Africa, China, and India has increased in recent years after being viewed for several years as expensive and unprofitable. In addition, in more mature markets such as North America and Western Europe, there is a strong upgrade rate as operators continue to offer attractive new devices to replace customers' outdated devices. Strong performance was experienced in the EMEA and Asia and South Pacific regions, which experienced growth rates of 3.5 percent and 26 percent over the prior year period, respectively. Strong growth in the North America market continued, reaching 45 million units by the end of the third quarter of 2007, a 10.3 percent increase over the same period in the prior year. Competition has continued to drive prices down at the low end of the market; at the same time, competition has also spurred new designs and features at the high end of the market, including the highly anticipated release of Apple's iPhone in the second quarter of 2007. In the third quarter of 2007, mobile phone sales totaled 289.1 million units, which was a 15 percent increase from the same period in 2006, according to Gartner Inc.

.26 *Convergence* seems to be the new buzzword for the wireless telecommunications industry. Cell phones now have multiple increased functionalities and can now function in sync with, or in place of, PCs and TVs. Apple's introduction of the iPhone is expected to spur even faster development of other similar products. As various wireless technologies converge on a single mobile device, their use is expected to increase dramatically.

.27 Gartner Inc. forecasts 2.3 trillion messages will be sent across the major networks worldwide in 2008, which would represent a 19.6 percent increase from the 1.9 trillion messages in 2007. Also, mobile messaging revenue is expected to grow at 15.7 percent in 2008 to $60.2 billion, up from $52 billion in 2007. Even though the volume of messaging will continue to increase, operator margins on messaging services are declining, largely seen as a result of competition and market saturation, according to Gartner Inc. The compound annual growth rate for short message service revenue in major markets worldwide from 2002 to 2006 was 29.8 percent; it is forecast at only 9.9 percent from 2007 to 2011.

.28 Broadband services continue to gain traction, particularly for the wireless technology known as WiMAX (worldwide interoperability for microwave access). Many municipalities have already implemented WiMAX systems to provide blanket coverage, and it is expected to become increasingly pervasive throughout 2008 as more equipment and networks are developed.

Software and Services

.29 An emerging trend within software and services is software as a service (SaaS). A September 2007 IDC-ITPartner.net survey indicates that SaaS is a key area of opportunity that may significantly affect the software partnering environment. The survey revealed that this area was a positive long-term option due to the high revenue annuity potential. Highlights from the survey include the following:

- Seventy-six percent of respondents believe SaaS will dramatically affect the partnering landscape.
- More than 70 percent of respondents view SaaS as an opportunity.
- Many of the surveyed firms are already engaged in SaaS-related activities.

- Implementation services and business services related to SaaS deployments are considered the most profitable opportunities associated with SaaS.
- To be successful, organizations must effectively target their partner messaging.

.30 IDC further highlighted this area in its "10 mega-trends for IT in 2008" forecast released in December 2007. They indicated online delivery, led primarily by SaaS, will have a significant impact on the high-technology industry. Other software-related items expected to have an impact in 2008 include the proliferation and influence of Web 2.0 applications, as well as solutions packaging.

Environmental Impact

.31 The increased importance on environmentally friendly products and producing products in an environmentally conscious way is affecting segments within the high-technology industry in various ways. High-technology companies are continually expected to produce more applications and products with increased computing power, which requires more energy consumption. On the other hand, other companies look to high-technology companies to provide technological solutions to environmental issues. As companies in all industries focus on making products that are more energy efficient and often make product comparisons and decisions based on responsible energy use, they may seek the assistance of high-technology companies. This may lead to new revenue opportunities as technology companies strive to create products and services to assist companies in other industries in becoming more environmentally friendly. To further demonstrate the industry's efforts, Gartner Inc. outlined three key steps to reduce organizational environmental footprints, defined as the combination of the energy consumed by the equipment, the environmental impact of its production, and the impact of its disposal. The three steps Gartner Inc. outlined to help organizations reduce their network environmental footprints are

1. don't overbuy,
2. minimize the number of layers and devices, and
3. consider power consumption of networking devices during product selection.

Audit and Attestation Issues and Developments

Audit Considerations for High-Technology Clients

.32 As discussed previously in this alert, auditors must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements. For audits of high-technology companies, an auditor may consider the following:

- Market and competition, including demand, capacity, and price competition, especially due to the fast rate at which these change in the high-technology industry
- Types of products and services being developed and marketed as well as corresponding life cycles
- Whether products are relatively standard or require significant customization
- Whether the entity has a practice of allowing customers to return products for new or upgraded models
- Whether the entity sells stand-alone products or a bundle of products and services (that is, multiple-element arrangements)
- Current marketing programs, for example, pricing incentives and the nature of any incentives that may affect the timing of revenue recognition

- Whether the entity uses a standard form of sales agreement (if standard sales agreements are not used, the processes by which sales agreements are evaluated for propriety of revenue recognition)
- Compensation plans for management and sales personnel that may provide an incentive to misstate revenue
- The general terms of the entity's arrangements with distributors and value-added resellers (VARs), if the entity uses them
- The kind of arrangements and warranty provisions the entity typically enters into with its end-user customers
- If sales are made internationally, the laws of the local jurisdiction relating to billing, transfer of title, or other items that may affect revenue recognition

The Competitive Environment

.33 The high-technology industry continues to be competitive. The industry uses a variety of pricing mechanisms and other product offerings to gain market share and increase customer base. A number of segments of the industry sell what is considered a commodity. If a product is considered a commodity, the primary means of differentiation is price, and it is not unusual for participants in the industry to engage in aggressive pricing practices or offer generous sales concessions to gain or retain market share.

.34 Rapid innovation and substantial technological change also continue to characterize the industry. New industry players and products continually emerge, and companies are under constant pressure to enhance the capabilities and quality of their products and services. Clients whose products become technologically inferior become vulnerable to customer demands for price or other concessions.

.35 Constant technological advancement affects the industry in many ways, including the following:

- The threat of imminent product obsolescence provides an additional incentive for high-technology manufacturers to offer discounts or provide other incentives and concessions as a way to make sales and move inventory. Many concessions raise questions about the propriety or timing of revenue recognition.
- Rapid technological change has resulted in the creation of even more complex high-technology products. In some instances, it may be difficult to determine whether the product will perform as required at the time of shipment. To overcome customer resistance in those situations, manufacturers may engage in a number of practices that have revenue recognition implications, including
  — delivering products to customers for demonstration purposes;
  — providing liberal evaluation, acceptance, or cancellation clauses in the sales contract;
  — offering separately priced extended warranties or maintenance agreements; or
  — promising the delivery of future products (before these products are complete, the entity will ship current products to the customer).
- The quick pace of innovation can force companies to speed new products to the market. The constant introduction of new products may raise questions about an entity's ability to estimate product returns.
- The rapid pace of changes results in companies constantly evaluating and modifying their business model and how their products are brought to market. For example, as products near the end of their life cycle, an entity may offer sales incentives or introduce other strategies for extending the sales life of the product.

.36 The pressure to meet quarterly or annual earnings targets creates a strong incentive for entities to complete transactions by the end of the reporting period. Customers can take advantage of this desire to meet revenue expectations by forcing companies to lower prices or provide more liberal sales terms in contracts negotiated near the end of a reporting period. For this reason, it is not uncommon for high-technology companies to report a proportionately higher number of sales near the end of a reporting period. This situation can lead to a greater risk of material misstatement to the financial statements.

Outsourcing

.37 A 2007 employment study by the AeA shows that the U.S. high-technology industry added 118,500 jobs between January and June of 2007. This is the third straight year that the U.S. high-technology industry has added jobs, and it is the first year since 2001 that each of 4 sectors the AeA considers within the industry (high-technology manufacturing, communications services, software services, and engineering and technology services) has increased the number of jobs. The industry added almost 150,000 jobs in 2006 according to the AeA, which was the largest gain since 2001. These results counter the thought that high-technology jobs are increasingly being outsourced. While many companies have outsourced positions such as software development and call centers to locations such as India and Russia, there is such demand for employees that outsourcing cannot meet all of the U.S. needs.

Expanding Into Nontraditional Areas

.38 High-technology companies that add or expand products, services, and businesses may generate audit risks and risks to themselves. You may consider the following factors if your client is adding or expanding products, services, or businesses:

- Management may lack expertise in the new areas. For example, cable companies may not possess the knowledge and skills needed to manage the business and risk of providing Internet-based phone services. This lack of expertise may contribute to financial statement misstatements and internal control weaknesses.
- Management may not properly implement industry-specific accounting principles related to the new areas resulting in material misstatements of the financial statements.
- The accounting, operations, and other systems related to the new areas may lack adequate testing and proper integration with core systems. Thus, these new systems may have inadequate internal control, which may result in unreliable accounting data and lead to material misstatements of the financial statements.
- The entity may fail to comply with regulations attendant to the new area of business (such as Federal Communications Commission regulations) because of unfamiliarity with the regulations and a lack of expertise in the new area. AU section 317 describes an auditor's responsibilities regarding violations of laws or governmental regulations.

Increased Merger and Acquisition Activity

.39 Because mergers and acquisitions of high-technology companies have become more frequent, the following sections are included to summarize some considerations relating to mergers and acquisitions.

Applicable Accounting Guidance

.40 Financial Accounting Standards Board (FASB) Statement No. 141(R), *Business Combinations*, and FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*, were issued in December 2007 and are discussed subsequently in this alert.

Possible Internal Control Weaknesses

.41 Subsequent to a merger, management typically reduces personnel and eliminates positions and functions in hopes of saving money and gaining efficiencies. Management may shift personnel to different positions and alter standard operating procedures. By making these changes, however, management may risk creating deficiencies in internal control and in business operations. Such deficiencies in internal control may represent significant deficiencies or material weaknesses. Auditors must consider the guidance in AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1), with regard to what communication is required when significant deficiencies or material weaknesses are identified in an audit.

Increased Fraud Risks

.42 Employees may have an increased opportunity to commit fraud when entities merge. With major changes in the entity's operations, there may be breakdowns in internal control, including the poor segregation of duties and a lack of supervisory reviews, which employees can take advantage of by committing fraud. Furthermore, the bitterness that can follow a merger may trigger some employees to rationalize that the commission of fraud is justified. Auditors must consider the guidance in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1).

Spring Loading and Premerger Outlays

.43 An entity acquiring another entity may try to worsen the reported financial performance of the purchased entity during the period immediately preceding the acquisition date (the stub period). By worsening the financial performance of the acquired entity 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 an increase in reported earnings. This practice is often referred to as spring loading. Generally, the practice involves accelerating the purchased entity's payment of payables and other obligations and writing down investments and other assets on the purchased entity's books. Some of these practices, such as paying down payables, may not necessarily violate generally accepted accounting principles (GAAP); however, other financial engineering techniques do violate GAAP because they may involve the deliberate inflation of reserves and allowances recorded on the acquired entity'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 in this manner include, among others:

- Reserves for merger costs
- Inventory obsolescence allowance
- Pension allowances
- Restructuring reserves
- Reserves for worker's compensation and medical insurance

.44 AU section 315, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1), says the successor auditor must obtain sufficient appropriate audit evidence to afford a reasonable basis for expressing an opinion on the financial statements he or she has been engaged to audit, including evaluating the consistency of the application of accounting principles. The audit evidence used in analyzing the impact of the opening balances on the current-year financial statements and consistency of accounting principles is a matter professional judgment. Auditors must consider guidance in AU section 315.

Compliance With the Sarbanes-Oxley Act

.45 Management of public companies may fail to consider the effect of the Sarbanes-Oxley Act of 2002 and related Securities and Exchange Commission (SEC) regulations on the merger. For example, an entity may encounter a serious challenge if it acquires a privately held entity that has not had to comply with the act. Effective controls may not be in place at the acquired entity. When performing an integrated audit of financial statements and internal control over financial reporting, auditors must consider the guidance contained in Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which replaced Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

Revenue Recognition

.46 Revenue recognition continues to pose significant audit risk for auditors, and the high-technology industry is one of the more challenging industries when it comes to the topic of revenue recognition. The SEC sought to fill the gap in the accounting literature with Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, which was issued in December 1999, and the companion document, *Revenue Recognition in Financial Statements—Frequently Asked Questions and Answers*, which was issued in October 2000. SAB No. 101 was superseded by SAB No. 104, *Revenue Recognition*, in December 2003. SAB No. 104 states that if a transaction falls within the scope of specific authoritative literature on revenue recognition, that guidance should be followed; in the absence of such guidance, the revenue recognition criteria in FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, should be applied. Specifically, the criteria that revenue should not be recognized until it is (*a*) realized or realizable and (*b*) earned should be followed. However, SAB No. 104 is more specific, stating additional requirements for meeting those criteria, and reflects the SEC staff's view that the 4 basic criteria for revenue recognition in AICPA Statement of Position (SOP) 97-2, *Software Revenue Recognition* (AICPA, *Technical Practice Aids*, ACC sec. 10,700), should be a foundation for all basic revenue recognition principles. Those criteria are as follows:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred.
- The vendor's fee is fixed or determinable.
- Collectibility is probable.

.47 The SEC has seen a number of instances of questionable and inappropriate revenue recognition practices. Significant issues encountered include

- complex arrangements that provide for separate, multiple deliverables (for example, multiple products or services, or both), at different points in time during the contract term.
- nonmonetary (for example, barter) transactions in which fair values are not readily determinable with a sufficient degree of reliability.

.48 The SEC 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; APB Opinion No. 29, *Accounting for Nonmonetary Transactions*; SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (AICPA, *Technical Practice Aids*, ACC sec. 10,330); FASB Concept Statement No. 5; and FASB Concept Statement No. 6, *Elements of Financial Statements*.

.49 In an industry as varied as high technology, invariably there will be significant differences among companies regarding the types of products and services sold and how they are sold. Characteristics of high-technology revenue transactions that may affect revenue recognition include the following:

- *Bundled sales.* The bundling of installation or other services with product sales can complicate the revenue recognition process.

- *Indirect versus direct selling.* Many high-technology companies use a combination of direct sales with a network of VARs and distributors to sell their products to end users. Sales made through distributors, as well as significant single sales, often can have unique, nonstandard terms. It is common for high-technology companies to provide incentives or sales concessions to their VARs and distributors that go beyond the rights of return granted to end users. Many of the incentives and concessions raise revenue recognition issues.

- *Bill-and-hold sales.* It is not uncommon for high-technology companies to enter into bill-and-hold transactions. In a bill-and-hold transaction, a customer agrees to purchase the goods, but the seller retains physical possession until the customer requests shipment. Normally, such an arrangement does not qualify as a sale because delivery has not occurred.

- *International sales.* High-technology companies may make sales in non-U.S. legal jurisdictions. The laws in these jurisdictions relating to product sales can vary significantly from U.S. laws. For example, some countries may prohibit the billing for goods until delivery occurs or may have rules regarding transfer of title that may be significantly different from U.S. rules.

AICPA's Audit Guide on Revenue Recognition

.50 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. Included in this guide are descriptions and explanations of auditing standards, procedures, and practices as they relate to auditing assertions about revenue in both the computer software and high-technology manufacturing industries.

.51 This guide, updated as of May 1, 2007, does the following:

- 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

- Reflects the issuance of SAS Nos. 104–111, the "risk assessment standards," and has been conformed to the new risk assessments standards to indicate, at a minimum, where these standards need to be applied

.52 You can order the AICPA Audit Guide *Auditing Revenue in Certain Industries* (product no. 012517kk) from the AICPA at (877) 777-7077 or visit www.cpa2biz.com.

Foreign Currency Hedges

.53 The multinational nature of the computer hardware industry means that companies within this industry can be greatly affected by changes in the dollar's value versus other currencies. Revenues can be affected if the entity generates a significant portion of its sales from outside the United States, and expenses can also be affected if the entity has a significant operating presence in international markets. The increasing level of global exposure can often cause wide variations in these companies' operating results. To limit the financial risk associated with these currency fluctuations, companies are therefore increasing their usage of hedging techniques, according to Standard & Poor's. However, it is still important to understand both the net impact of currency swings on reported financial statements and the actual level of business activity on a constant currency basis.

Accounting Issues and Developments

Revenue Recognition

.54 High-technology manufacturing companies can be involved in a variety of revenue transactions. Certain of these transactions fall within the scope of specific authoritative literature. For other transactions, only the broad revenue recognition criteria specified in the FASB's conceptual framework exists.

.55 To assess whether the client's revenue recognition policies are consistent with the applicable accounting literature, auditors may consider identifying and understanding the terms of the entity's revenue transactions and whether these terms are consistent for all customer types.

Income Statement Classification

.56 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, an auditor may consider 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. Some recently issued EITF consensus provisions include

- EITF Issue No. 06-1, "Accounting for Consideration Given by a Service Provider to Manufacturers or Resellers of Equipment Necessary for an End-Customer to Receive Service from the Service Provider"
- EITF Issue No. 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities"

.57 SEC registrants apply the guidance provided in SEC Regulation S-X regarding classification of amounts in financial statements.

Research and Development Costs

.58 As noted in last year's alert, ongoing innovation is the heart of competition in the high-technology industry and is required for survival. Consequently, most high-technology 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.

.59 High-technology 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. (FIN) 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.

.60 Some high-technology 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 may consider verifying that they are properly valued and capitalized.

Convergence With International Financial Reporting Standards

.61 Since their joint meeting in September 2002, the FASB and International Accounting Standards Board (IASB) have had a common goal—one set of accounting standards for international use. At that time, The Norwalk Agreement, a memorandum of understanding between the two rule-setting bodies, was signed. In this agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. At that meeting, the FASB and the IASB pledged to use their best efforts to make their existing financial reporting standards fully compatible as soon as is practicable and to coordinate their future work programs to ensure that once achieved, compatibility is maintained. At their meetings in April and October 2005, the FASB and IASB reaffirmed their commitment to the convergence of U.S. GAAP and International Financial Reporting Standards (IFRS). A common set of high quality global standards remains the long-term strategic priority of both the FASB and the IASB.

.62 There has been progress towards this goal. FASB Statement No. 157, *Fair Value Measurements*, and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, take U.S. GAAP in the direction of IFRS with respect to reporting at fair value. The goal of the FASB and the IASB is to reach a conclusion in 2008 about whether major differences in a few focused areas should be eliminated through one or more short-term standard-setting projects and, if so, complete or substantially complete work in those areas. Those areas include impairment, income taxes, investment properties, government grants, research and development, joint ventures, subsequent events, and segment reporting. For more information on the status of this project go to www.fasb.org and www.iasb.org.

SEC Eases Acceptance of IFRS Financial Statements

.63 On December 21, 2007, the SEC adopted rules to accept from foreign private issuers financial statements prepared in accordance with IFRS as issued by the IASB without reconciliation to U.S. GAAP. This rule marks an important step in the process toward the development of a single set of high quality, globally-accepted accounting standards. This rule was effective March 4, 2008. Readers can access this rule at www.sec.gov/rules/final/2007/33-8879.pdf.

.64 Over 100 countries now either require or allow the use of IFRS for the preparation of financial statements by listed companies, and other countries are moving to do the same. This recent movement to IFRS outside the United States has resulted in an increase, from a relative few in 2005 to approximately 110 in 2006, of filings with the SEC of foreign private issuers that represent in the footnotes to their financial statements that their financial statements comply with IFRS as published by the IASB. The SEC expects to see this number continue to increase in the future, particularly pursuant to Canada's announced move to IFRS, as there currently are approximately 500 foreign private issuers from Canada.

.65 This movement to IFRS also has begun to affect U.S. issuers, in particular those with a significant global footprint. For instance, certain U.S. issuers may compete for capital globally in industry sectors in which a critical mass of non-U.S. companies report under IFRS. Also, U.S. issuers with subsidiaries located in jurisdictions that have moved to IFRS may prepare those subsidiaries' financial statements in IFRS for purposes of local regulatory or statutory filings. Readers should remain alert to developments regarding convergence.

FASB Accounting Standards Codification™

.66 On January 15, 2008, FASB launched the one-year verification period of the *FASB Accounting Standards Codification™* (codification). The codification is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by providing all authoritative literature in a topically organized structure. The codification includes all accounting standards issued by a standard setter within levels A–D of the current U.S. GAAP hierarchy, including FASB, AICPA, EITF, and related literature. The codification also includes relevant authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance.

.67 The codification does not change GAAP, but rather it reorganizes thousands of GAAP pronouncements into approximately 90 topics. Therefore, the one-year verification period is not to debate the underlying requirements of GAAP, but rather to verify that the codification appropriately captures them and accurately reflects existing U.S. GAAP for nongovernmental entities. The verification period is also a period for constituents to acquaint themselves with the new structure and submit feedback regarding any issues before the codification content becomes authoritative. At the end of the one-year verification period, FASB is expected to formally approve the codification as the single source of authoritative U.S. accounting and reporting standards, other than guidance issued by the SEC. At that time, FASB will supersede all then-existing non-SEC accounting and reporting standards. All other nongrandfathered, non-SEC accounting literature not included in the codification will become nonauthoritative. FASB expects to approve the codification in April 2009.

.68 The codification uses a topical structure in which topics, subtopics, and sections are numerically referenced. This effectively organizes the content without regard to the original standard-setter or standard from which the content was derived. The topics of the codification reside in four main areas: presentation, financial statement accounts, broad transactions, and industry guidance. The overall presentation area addresses presentation of financial information but does not address items such as recognition, measurement, or derecognition. For example, topics in this area include income statement, balance sheet, and earnings per share. The financial statement account area presents topics in financial statement order including assets, liabilities, equity, revenue, and expenses. The broad transactions area includes topics related to multiple financial statement accounts that are transaction-oriented such as derivatives and business combinations. The industry area includes guidance unique to an industry or type of activity such as airlines, software, and real estate.

.69 Constituents are encouraged to use FASB's online Codification Research System free of charge and provide feedback to FASB on the codification. The Codification Research System includes general information on how to use the online research system and special features such as Cross Reference Reports, which show where current standards reside in the codification. Readers are encouraged to register and access the codification at www.fasb.org/project/codification&retrieval_project.shtml.

XBRL Initiative

.70 eXtensible Business Reporting Language (XBRL) is an XML-based markup language used to communicate financial and business data electronically. XBRL is being developed by an international nonprofit consortium with over 450 member organizations, including accounting firms, software providers, financial intermediaries, academics, and technologists.

.71 XBRL is used to "tag" financial statements so that the information in those statements is machine readable, thereby allowing users to analyze financial information more easily and quickly. To assist with the tagging process, XBRL US has currently developed over 11,000 financial concepts, which essentially represent a dictionary of U.S. GAAP and other financial reporting requirements.

.72 On January 11, 2008, the SEC Advisory Committee on Improvement to Financial Reporting proposed that the SEC adopt a mandatory phase-in of XBRL for a specified time period, starting with the largest 500 domestic public reporting companies. As of the date of this alert, that mandatory phase-in period had not yet been determined. Be sure to check the SEC's Interactive Data link at www.sec.gov to view the current status of the project.

.73 For more information on XBRL, visit the XBRL site at www.xbrl.org.

Recent Auditing and Attestation Pronouncements and Related Guidance

.74 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.75 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by visiting www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with GAAS)	This standard replaces SAS No. 61, *Communication With Audit Committees*. The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards*, to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120). • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
	• Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report.* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report.
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	See the "AICPA Risk Assessment Standards" section in this alert.
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325 par. .01–.04), of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325 (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330 par .01–.06), of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
Statement of Position (SOP) 07-2, *Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisors, or Other Service Providers* (AICPA, *Technical Practice Aids*, AUD sec. 14,430) Issue Date: October 2007 (Interpretive publication)	This statement addresses the application of SSAEs primarily to examination engagements in which a practitioner reports on the suitability of the design and operating effectiveness of a service provider's controls in achieving specified compliance control objectives. Examples of the service providers addressed by this SOP are investment advisers, custodians, transfer agents, administrators, and principal underwriters that provide services to investment companies, investment advisers, or other service providers.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.
TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This practice aid is a response to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.
AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This practice aid provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditor's report.
PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This standard replaces the PCAOB's previous internal control standard, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.
PCAOB Rule 3525, *Audit Committee Preapproval of Nonaudit Services Related to Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Rules") Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client's audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the SEC or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm's independence, and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524. This rule is effective for audits of fiscal years ending on or after November 15, 2007.

Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Conforming Amendments to the Interim Auditing Standards (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards") Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in appendix 3 of PCAOB Release No. 2007-005A at www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.
PCAOB Report, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (AICPA, *PCAOB Standards and Related Rules*, "Selected SEC-Approved PCAOB Releases") Issue Date: January 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report focuses on aspects of the PCAOB's interim auditing standards that address the auditor's responsibility with respect to fraud, specifically AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.
PCAOB Staff Questions and Answers, *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 100—PCAOB Staff Questions and Answers") Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	Topics covered include the following: • The application of Rule 3522(a) when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm • Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction • Whether a registered public accounting firm's independence is affected by the IRS's subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b) • Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself • Clarification of the term *other change in employment event* as it relates to Rule 3522(c)

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Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 400—Staff Audit Practice Alerts") Issue Date: December 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of GAAP that are particularly relevant to the current economic environment.

The Auditor's Communication With Those Charged With Governance

.76 In December 2006, the Auditing Standards Board (ASB) issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees*. This SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and became effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to entities that either have an audit committee or have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.77 SAS No. 114 provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires that significant matters communicated with those charged with governance be documented.

Identifying Those Charged With Governance

.78 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those 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.

.79 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.80 Because there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.81 The ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which became effective for audits of financial statements for periods ending on or after December 15, 2006. SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. This SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion). Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued, the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2. However, with the adoption of PCAOB Auditing Standard No. 5 the PCAOB redefined these terms, which now differ from SAS No. 112.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.
- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, and identifies indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.
- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.
- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.
- Contains illustrative written communications to management and those charged with governance.

Discussions With Management and Others

.82 The requirements of SAS No. 112 have changed perceptions regarding the auditor's role in the client's internal control in some circumstances. Auditors may have to continue to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm, other than the auditor, that does not provide attest services for the client can be part of a client's internal control. This may continue to raise questions regarding the role of outsourcing in achieving management's internal control objectives.

.83 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of material weaknesses. Another reason is that auditors have to include in written communication significant deficiencies and material weaknesses that were identified and communicated in previous years, for as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.84 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented or detected and corrected, by the client.

Issues for Audits of Smaller Entities

.85 One issue that may arise in audits of smaller entities is the increase in time and costs the auditor may spend documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.86 Another issue that has caused concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, or detecting and correcting, material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, because doing so would impair independence.[1] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.87 The requirements of SAS No. 112 will continue to introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing.

.88 The AICPA published Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides

[1] See Ethics Interpretation No. 101-3, "Performance of nonattest services," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

AICPA Risk Assessment Standards

.89 The eight SASs referred to as the risk assessment standards (SAS Nos. 104–111) became effective for audits of financial statements for periods beginning on or after December 15, 2006, (earlier application was permitted), which means they are effective for 2007 calendar year audits. Although the SASs include many of the underlying concepts and detailed performance requirements contained in the standards they amend or supersede, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risks of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between the risks, controls, audit procedures, and conclusions.

Key Provisions of the Risk Assessment Standards

.90 Whether due to error or fraud, the risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks that may lead to a material misstatement in the client's financial statements and any mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations of the Treadway Commission's (COSO) framework, www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs should have already been completed and has likely resulted in significant changes to firm audit methodologies and personnel training.

.91 The AICPA issued Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk), which can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. The AICPA has also issued a number of questions and answers based upon member inquiries in the fall edition of the *In Our Opinion* newsletter. That newsletter can be accessed at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion/.

Companion Audit Guide

.92 In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors further understand the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Audit Documentation Technical Practice Aids

.93 In May 2007, the ASB issued two Technical Practice Aid (TPA) Technical Questions and Answers (TIS) related to SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which was issued in December 2005.

.94 TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.95 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*), discusses whether the provisions of SAS No. 103 related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance*

.96 A key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms, an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.97 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date
- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.98 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf.

PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*

.99 In January 2008, the PCAOB adopted Auditing Standard No. 6, which will become effective 60 days after SEC approval. This standard and its related amendments update the auditor's responsibilities to evaluate and report on the consistency of a company's financial statements and align the auditor's responsibilities with FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion No. 20 and FASB Statement No. 3*. This standard also improves the auditor reporting requirements by clarifying that the auditor's report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principle or the correction of a misstatement.

.100 In the same release, the PCAOB adopted several amendments to its interim standards relating to standards and interpretations of AU section 328, the AU 400 sections, AU section 508, and AU section 561 of the PCAOB's standards. In these amendments the PCAOB removed the GAAP hierarchy from its standards as it believes the hierarchy is more appropriately located in the accounting standards. FASB intends to incorporate the hierarchy into the accounting standards. For more information on the status of this adopted standard and its associated amendments, please visit www.pcaob.org.

PCAOB Auditing Standard No. 5

.101 The SEC approved Auditing Standard No. 5 on July 25, 2007. This standard replaces Auditing Standard No. 2. Auditing Standard No. 5 is principles-based and presents a risk-based, top-down approach designed to increase the likelihood that material weaknesses will be found before resulting in a material misstatement of a company's financial statements, while eliminating unnecessary procedures. The standard was also designed to make audits more scaleable for smaller or less complex companies. The PCAOB worked closely with the SEC to coordinate Auditing Standard No. 5 with the guidance to public company management that was approved by the SEC in May 2007. Mark Olson, PCAOB Chairman, stated "The new standard is more risk-based and scalable, which will better meet the needs of investors, public companies, and auditors alike."

.102 This standard is required for all audits of internal control for fiscal years ending on or after November 15, 2007. For more information, readers may refer to *SEC and PCAOB Alert—2007/08* (product no. 022498kk).

Recent AICPA Independence and Ethics Pronouncements

.103 AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.104 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 160 (December 2007)	*Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*
FASB Statement No. 141 (revised 2007) (December 2007)	*Business Combinations*
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*

(continued)

Recent Accounting Pronouncements and Related Guidance	
FASB Interpretation No. (FIN) 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* FASB Staff Position (FSP) FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, issued in February 2008, defers the effective date of FIN 48 for certain nonpublic enterprises, as defined in the FSP, to the annual financial statements for fiscal years beginning after December 15, 2007.
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF issues.
FASB Staff Positions (FSPs) (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA Statement of Position (SOP) 07-1 (AICPA, *Technical Practice Aids*, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies* In February 2008, FASB issued FSP SOP 07-1-1, *Effective Date of AICPA Statement of Position 07-1*, which indefinitely defers the effective date of SOP 07-1 and prohibits adoption of the SOP for an entity that has not early adopted the SOP before issuance of this FSP. An entity that early adopted the SOP before issuance of this FSP, is permitted, but not required to continue to apply the provisions of the SOP. Entities that elect to retain their adoption of the guidance must all apply it to all consolidated entities going forward, including those formed or acquired after the adoption of SOP 07-1.
TIS section 6140.20–.22 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss not-for-profit organizations fund-raising expenses.
TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various employee benefit plan topics.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.105 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the high-technology 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. The AICPA general *Audit Risk Alert—2007/08* and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or visit www.cpa2biz.com.

Business Combinations

.106 In December 2007, FASB issued FASB Statement No. 141(R) and FASB Statement No. 160. These standards strive not only to improve and simplify the accounting for business combinations and the reporting of noncontrolling interests in consolidated financial statements, but also to converge with international standards. The issuance of these standards marks the completion of FASB's first major joint project with the IASB.

.107 FASB Statement No. 141(R) requires the acquiring entity in a business combination to recognize all the assets acquired and liability assumed in the transaction; establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. FASB states that FASB Statement No. 141(R) will also decrease the complexity of existing GAAP because the new standard includes both core principles and application guidance, eliminating the need for other interpretive guidance. FASB Statement No. 141(R) is to be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. An entity may not apply the standard before this date.

.108 FASB Statement No. 160 improves the relevance, comparability, and transparency of financial information by requiring all entities to report noncontrolling (minority) interests in subsidiaries in the same way—as equity in the consolidated financial statements. FASB Statement No. 160 also eliminates the diversity in accounting for transactions between an entity and noncontrolling interests by requiring they be treated as equity transactions. FASB Statement No. 160 is effective for fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2008 (for calendar year end companies January 1, 2009). Earlier adoption is prohibited. The standard is applied prospectively as of the beginning of the fiscal year in which the statement is initially applied, except for the presentation and disclosure requirements. Presentation and disclosure requirements shall be applied retrospectively for all periods presented.

Fair Value Measurements

FASB Statement No. 157

.109 In September 2006, FASB issued Statement No. 157 to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

.110 Prior to this statement, there were different definitions of fair value, and guidance for applying those definitions was dispersed among many accounting pronouncements. Difference in the existing guidance created inconsistencies that added to the complexity in applying GAAP. FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period.

.111 In February 2008, the FASB issued FASB Staff Position (FSP) FAS 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13*, which amends FASB Statement No. 157, to exclude FASB Statement No. 13, *Accounting for Leases*, and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under FASB Statement No. 13. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under FASB Statement No. 141 or FASB Statement

No. 141(R), regardless of whether those assets and liabilities are related to leases. This FSP is effective upon the initial adoption of FASB Statement No. 157.

.112 FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. However, in February 2008, FASB issued FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, which is effective upon issuance. This FSP delays the effective date of FASB Statement No. 157 until fiscal years beginning after November 15, 2008 and interim periods within those fiscal years for fair value measurements of all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow the FASB and its constituents the time to consider the various implementation issues associated with FASB Statement No. 157. Readers can access the full text of FASB Statement No. 157 on the FASB Web site at www.fasb.org.

FASB Statement No. 159

.113 Subsequent to the issuance of FASB Statement No. 157, FASB issued Statement No. 159. This statement is expected to expand the use of fair value measurement, which is consistent with FASB's long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently, without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.114 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157. FASB and the SEC expressed concern in the way some early adopters applied the transition provisions of the standard. The AICPA Center for Audit Quality (CAQ) issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard, such as this, is applied in a good faith manner consistent with those objectives and principles. Specifically the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FASB Statement No. 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

Deferral of FIN 48 for Certain Nonpublic Entities

.115 FIN 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, was issued in June 2006 and is effective for fiscal years beginning after December 15, 2006. However, subsequent to its issuance the FASB issued FSP FIN 48-2, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, which defers the effective date of FIN 48 for nonpublic enterprises included in the FSP's scope to the annual financial statements for fiscal years beginning after December 15, 2007. For the full text of FIN 48 and its associated FSPs visit the FASB's Web site.

On the Horizon

.116 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the high-technology industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.117 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Auditing Pipeline—Nonissuers

ASB Clarity Project

.118 The ASB formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB issued a discussion paper titled *Improving the Clarity of ASB Standards*, seeking feedback on proposals to "clarify" its standards. In response to the feedback received on the discussion paper and subsequent discussions with interested parties, the ASB has established clarity drafting conventions and has undertaken to revise all of its SASs in accordance with those conventions. The clarity drafting conventions include the following:

- Establishing objectives for each of the standards, thereby providing a framework for the application of professional judgment
- Presenting application and other explanatory material in a separate section that follows the requirements
- Numbering application and other explanatory material paragraphs using an "A" prefix

- Cross-referencing introductory, objective, and requirement paragraphs to related application and other explanatory material paragraphs
- Using formatting techniques to enhance the readability of the SASs
- Including, where necessary, special considerations relevant to the audit of smaller, less complex entities within the text of the SAS
- Including, where necessary, any special considerations in the audit of governmental entities within the text of the SAS
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards

Convergence With International Standards

.119 The ASB is working toward convergence with international auditing standards, whereby projects are developed concurrently with those of the International Auditing and Assurance Standards Board (IAASB). The ASB has created a number of task forces charged with monitoring specific activities of the IAASB, assisting the ASB in commenting on exposure drafts of International Standards on Auditing (ISA), and drafting proposed SASs using the ISA, including the international convention for wording, as the base standard. The status of ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.120 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, the ASB previously decided to defer the issuance of a final revised AT section 501 until the PCAOB issued its amendments and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www.aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of **Present Fairly in Conformity With Generally Accepted Accounting Principles**

.121 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to FASB's proposed Statement of Financial Accounting Standards *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal places responsibility for the GAAP hierarchy for nongovernmental entities in the accounting literature. Accordingly, the proposed SAS deletes the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA, *Professional Standards*, vol. 1, AU sec. 411]). The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www.fasb.org. The ASB will issue its final SAS coincidentally with FASB's issuance of its final standards. As noted earlier in this alert, the PCAOB has already adopted its proposal to remove the GAAP hierarchy from its standards.

Auditing Pipeline—Issuers

.122 Guidance issued by the PCAOB is included in the section of this alert titled, "Recent Auditing and Attestation Pronouncements and Related Guidance." For more information regarding recent developments at both the SEC and PCAOB, readers may refer to *SEC and PCAOB Alert—2007/08* (product no. 022498kk), mentioned previously.

Accounting Pipeline

.123 Presented below are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year alert have not been finalized as of the date of this writing, and thus are included again.

Fair Value

.124 During phase one of FASB's fair value option project, FASB issued FASB Statement No. 159, which was previously discussed. In phase two of the project, FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase two are expected to begin in the first quarter of 2008. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.125 In December 2006, FASB issued an exposure draft titled, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure ended in March 2007, and FASB completed its redeliberations of the exposure draft in December 2007. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133, including how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entity's financial position, results of operations, and cash flows. FASB expects to issue a final statement during the first quarter of 2008. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.126 FASB is working on a project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, to address issues related to the permitted activities of a qualifying special-purpose entity (QSPE), isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, FASB issued the exposure draft *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During the second quarter of 2008, FASB expects to issue an amended exposure draft. See the FASB Web site for complete information.

Earnings Per Share

.127 FASB and IASB have been working together to resolve differences between FASB Statement No. 128, *Earnings per Share*, and International Accounting Standard (IAS) Statement No. 33, *Earnings per Share*. This project is part of the larger FASB project, Short-term International Convergence, which has resulted in the issuance of a number of FASB statements. Currently, FASB and IASB expect to issue an exposure draft for public comment during the first quarter of 2008. This exposure draft will be the third exposure draft the FASB has issued on the earnings per share project. The project and current exposure draft can be reviewed on the FASB Web site.

Income Taxes

.128 The objective of this project is to improve the accounting for income taxes and reduce the application differences between FASB Statement No. 109, *Accounting for Income Taxes*, and IAS Statement No. 12, *Income Taxes*. FASB plans to issue an exposure draft during the second quarter of 2008. Readers can track the project's progress on the FASB Web site.

GAAP Hierarchy

.129 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, FASB believes the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, which is responsible for selecting its accounting principles for financial statements. Accordingly, FASB concluded that the GAAP hierarchy should reside in the accounting literature established by FASB. FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonissuers" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.130 ***Proposed FASB EITF Issues.*** Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.131 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

.132 The following are various resources that practitioners engaged in the high-technology industry may find beneficial.

Publications

.133 Practitioners may find the following publications useful with respect to the high-technology industry:

- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2007) (product no. 012517kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2008) (product no. 012778kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- Audit Risk Alert *Compilation and Review Alert—2007/08* (product no. 022308kk)
- Audit Risk Alert *Independence and Ethics Alert—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)

- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.134 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. 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.

Continuing Professional Education

.135 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191 [DVD]). 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.
- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

.136 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.137 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com.

Webcasts

.138 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.139 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.140 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.141 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.142 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9am to 8pm on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+and+Auditing+Technical+Help/.

Ethics Hotline

.143 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.

AICPA CAQ

.144 The CAQ (formerly the Center for Public Company Audit Firms) was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.145 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

Industry Web Sites

.146 The Internet covers a vast amount of information that may be valuable to auditors of high-technology enterprises, including current industry trends and developments. Some of the more relevant sites for auditors with high-technology clients include those shown in the following table:

Organization	*Web Site*
Semiconductor Industry Association	www.sia-online.org
Interactive Data Corporation (IDC)	www.idc.com
Forrester Research	www.forrester.com
Gartner Research	www.gartner.com
American Electronics Association	www.aeanet.org

.147 The high-technology practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

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.148 This Audit Risk Alert replaces *High-Technology Industry Developments—2006/07*.

.149 The Audit Risk Alert *High-Technology Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to zdonahue@aicpa.org or write to

Zachary T. Donahue, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

.150

Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee (PCFRC)	Information on the initiative to further improve FASB's standard-setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org

Web Site Name	*Content*	*Web Site*
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov

[*The next page is 8481*.]

AAM Section 8140

Real Estate Industry Developments—2007/08

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
REAL ESTATE INDUSTRY DEVELOPMENTS—2007/08

This Audit Risk Alert is intended to provide auditors of financial statements of real estate organizations with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

Kristy L. Illuzzi, CPA
Technical Manager
Accounting and Auditing Publications

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your real estate industry audits. This alert can also be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory 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 financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The real estate industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic, and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the entity's financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, GDP increased at an annual rate of 2.9 percent in 2006, consistent with the pace of growth experienced in 2005 when GDP increased by 3.1 percent. During the first quarter of 2007, GDP increased by an annual rate of only 0.6 percent. However, according to second quarter preliminary estimates, GDP increased at an annual rate of 4.0 percent.

.11 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, with an annual average rate of 4.6 percent representing approximately 7 million people. The 2006 rates represent the lowest annual rate and total number of jobless since 2000, according to the U.S. Department of Labor, Bureau of Labor Statistics. During the first half of 2007, the unemployment rate averaged 4.5 percent. These data further demonstrate the economic growth the United States has experienced since the beginning of 2006.

.12 After a period of rising rates during the first half of 2006, the Federal Reserve kept its target for the federal funds rate at 5.25 percent for 10 consecutive meetings (June 2006–August 2007). At that time, the Federal Reserve indicated future federal fund rate adjustments would likely depend upon the outlook for economic growth and inflation. Since its August 2007 meeting and in response to shaky financial market conditions, the Federal Reserve has taken several action steps. It announced that it would provide reserves as necessary through the open market to facilitate the orderly functioning of financial markets by promoting trading in the federal funds market at rates close to the 5.25 percent target rate. On August 17, 2007, it announced that financial market conditions had deteriorated and tighter credit conditions and increased uncertainty have the potential to restrain economic growth. Then at its September meeting, the Federal Reserve decided to lower its target for the federal funds rate 50 basis points to 4.75 percent citing increased uncertainty surrounding the economic outlook. The Federal Reserve also decided to decrease the discount rate 50 basis points to 5.25 percent to consistently keep the spread between the primary credit rate and the federal funds rate at 50 basis points. Auditors should remain alert to developments in the financial markets and how they may affect your audit engagements.

Industry Trends and Conditions

.13 According to the Real Estate Roundtable,[1] more than 25 percent of inputs to GDP are generated by residential and commercial real estate. Real estate encompasses about $5 trillion worth of income-producing property and $15 trillion in owned-occupied housing and is a vitally important source of economic activity and tax revenue for government at all levels.

.14 As of the writing of this alert, the office, industrial, retail, and hospitality sectors are all showing signs of growth. In the office market, vacancy rates continue to fall, net absorption remains strong, and rents are on the rise in most areas. In the industrial sector, the market rebounded in the second quarter, and construction grew by 23 percent since 2006, which means demand is strong, especially for research and development (R&D) and flex space. The retail sector has seen some record breaking growth in 2007, although that is expected to decline in the later part of 2007.

.15 The residential market, however, is quite a different story, mainly due to the downturn in the housing market and ripple effect of the subprime lending crisis. The housing market continues to deteriorate and is not only slowing the economy directly, but may also cause consumers to decrease spending as a result of their anxiety about falling home prices. Also, there is growing concern that inflation may begin to accelerate

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[1] The Real Estate Roundtable is an organization that brings together leaders of the nation's top public and privately held real estate ownership, development, lending, and management firms with the leaders of major national real estate trade associations to jointly address key national policy issues relating to real estate and the overall economy. For further information, visit their Web site at www.rer.org.

in our economy. High oil prices continue to add pressure to inflation, and long-term interest rates have begun to trend up recently. In addition, 2007 may be the first year in the last eight that Real Estate Investment Trusts (REITs) do not outperform other stock groups and indexes.

Industry Segment Conditions

Office Market Conditions

.16 The office market continues to recover from its downturn in the early 2000s. Vacancy rates continue to fall, net absorption remains strong, and rents are increasing in most markets. According to the commercial real estate services firm Grubb & Ellis Company, the U.S. office vacancy rate ended the second quarter of 2007 at 13 percent, its 13th consecutive quarterly decline. Net absorption of 21.2 million square feet was the highest since the fourth quarter of 2005, signaling that the expansion cycle is still in high gear.

.17 The average asking rent rose an impressive 12 percent for Class A space over the past 4 quarters and 8 percent for Class B space. The acceleration of Class A rates over the past year is a function of several forces, including tenant demand, the addition of new Class A properties that typically charge premium rates, and aggressive landlords who need to increase cash flow in order to meet their proformas for recently purchased properties. While Class A properties typically get the most attention, the acceleration of Class B rates over the past year is perhaps even more impressive because it shows that the current expansion cycle has filtered down to lesser quality (but still functional) properties.

.18 Markets with rent gains of more than 25 percent over the past four quarters include San Mateo, New York, Austin, Boston, San Francisco, and Houston. On the other hand, Class A rates fell 6.6 percent in Detroit, although the city did have several large lease transactions and positive net absorption in the second quarter of 2007.

.19 According to Grubb & Ellis Company, the outlook for the office market appears brighter now, in 2007, than it did just one year ago. The economy has continued to generate jobs, the primary driver of demand for office space, while corporate profits continue to exceed expectations. They predict the office vacancy rate will continue to fall over the next few quarters, while rental rates will continue to increase. The construction pipeline will slowly expand as developers and lenders tap into a landlord's market that is growing broader by the month.

Industrial Market Conditions

.20 According to Grubb & Ellis Company, the industrial market rebounded during the second quarter of 2007. Net absorption exceeded space completions by approximately 14 million square feet, enough to push the vacancy rate down another 10 basis points to 7.6 percent. Space under construction has increased 23 percent since year-end 2006 to 141 million square feet, suggesting that vacancy is unlikely to fall much further. In addition, asking rental rates were flat year-over-year for warehouse and distribution space and up by 10.3 percent for R&D and flex space.

.21 Among the major U.S. markets, second quarter vacancy was lowest in Los Angeles at a low 1.8 percent and the highest in Raleigh-Durham at 15.7 percent. Los Angeles has experienced a two percent or less vacancy rate for over one year thanks to exploding trade through the ports of Los Angeles and Long Beach and a very small supply of developable land. Although the Raleigh-Durham market has tightened in seven of the past eight quarters, vacancy remains high from the technology downturn several years ago.

.22 The average asking rental rate for warehouse and distribution space remains flat even though the industrial market is in an expansion cycle. There are several likely reasons for this: the massive construction pipeline; the migration of development farther from urban areas; and the fact that large distribution centers, which typically command lower per-square-foot rates than smaller properties, dominate the construction pipeline. The average asking rate for warehouse and distribution space available at mid-year was $4.47 per square foot per year, down 6 cents over the prior 4 quarters. Despite this overall decrease, there were some markets with net growth, including South Florida's Broward and Palm Beach counties and San Jose and Silicon Valley, California.

.23 Rental rates for R&D and flex space have risen consistently over the past 4 quarters, with the average asking rate rising to $10.33 as of June 2007, up 10.3 percent from a year ago. As office space rents continue to rise, more tenants are looking into R&D and flex space for lower rates.

.24 According to Grubb & Ellis Company, demand for distribution space will remain high, particularly around seaports, airports, and "inland ports" (multimodal logistics hubs). Even in smaller markets beyond the logistics hot spots, demand for industrial space should remain very strong.

Retail Market Conditions

.25 The last 12 months have seen record-setting retail sales and solid retail leasing activity. Retailers continue to expand, and shopping center construction is robust, particularly lifestyle centers, power centers, and mixed-use infill projects with a retail component. However, due to the economic downturn (which includes high gasoline prices, the slump in the housing market, and the related mortgage crisis), retail sales growth is expected to decline in the second half of 2007.

.26 Markets that continue to grow include Texas, Arizona, Nevada, New Mexico, and Southern California. Markets in Florida and the Southeast have been strong over the last five years and continue to expand. The struggling domestic auto industry is limiting the growth of consumer spending in the Great Lakes states.

.27 Overall, construction remains modest, leaving the national vacancy rate at just above seven percent. According to Colliers International, rents continue to increase at three percent to four percent per year, although certain prime retail strips registered rental increases well into the double digits. With this positive backdrop, investors have been rewarded with above average returns ranging from 10 percent to 30 percent for the past several years.

Residential Market Conditions

.28 The residential real estate market has probably experienced the most dramatic changes over the prior year. In 2006, after five years of record sales and growth, the market slowed, and since then the outlook for the residential housing market has appeared bleaker than ever. The market has been plagued with a drop in housing prices coupled with increased foreclosures and the subprime lending crisis.

.29 The number of foreclosure filings reported in the United States in August 2007 more than doubled the number in August 2006 and jumped 36 percent from July 2007. This trend signals that many homeowners are increasingly unable to make timely payments on their mortgages. According to RealtyTrac Inc., a total of 243,947 foreclosure filings were reported in August 2007, up 115 percent from 113,300 in the same month a year ago. The August 2007 total represents the highest number of foreclosure filings reported in a single month since the company began tracking monthly filings two years ago. There was one foreclosure filing for every 134 U.S. households during the first half of the year according to RealtyTrac's midyear report. Nevada, California, and Florida had the highest foreclosure rates in the country in August. The Mortgage Bankers Association reports that 550,000 homeowners with subprime loans began a foreclosure process over the last year, and specialists say that number could double in the next couple of years. In October 2007 alone, more than $50 billion in adjustable rates mortgages (ARMs) will reset.

.30 To provide further insight as to how dramatic these interest rate changes could be on these ARMs, consider the following example. A buyer in 2005 with poor credit and limited means might have signed on for a $200,000 2/28 hybrid ARM, locking in a fixed rate of 4 percent for a period of 2 years. After paying $955 a month, his or her monthly mortgage would now be set to spike to $1,331, a 39 percent increase.

.31 To better understand the dramatic increase in foreclosure activity, it is important to reflect back a couple of years to when the problems began. During the height of the housing boom in 2005 and 2006, lending institutions were offering subprime loans and ARMs that initially have low "teaser" interest rates but then adjust upward. In addition, many lending institutions had loosened their lending policies, and recently some have been charged with falsification of loan documents or lack of support for borrower's income. Builders have also been blamed for some of the foreclosures, mainly due to their increased involvement in the mortgage business. In a rush to fill vacancies for new construction, builders were offering loans that were more than potential homeowners could afford. Several construction companies have also recently been accused of falsifying mortgage documents or not having proper support for homeowner's income. This has led to the closing of many financial institutions and construction companies and has forced some financial institutions to borrow from the Federal Reserve.

.32 More than half a dozen residential lenders have declared bankruptcy in 2007 as defaults spilled over from subprime borrowers with the worst repayment records to those with more reliable payment histories. For the year, the widely followed KBW Bank Index of the 24 largest lenders has fallen 10 percent and has caused a shakeup in the S&P 500 Index. Subprime mortgage industry shares make up 20 percent of the S&P 500 stock index. Without those shares, through July the S&P 500 would have been up by 5.6 percent in 2007. Instead, it has only grown by 2.6 percent.

.33 Since the start of the year, more than 40,000 workers have lost their jobs at mortgage lending institutions according to recent company layoff announcements and data compiled by global outplacement firm Challenger, Gray & Christmas, Inc. Meanwhile, construction companies have announced nearly 20,000 job cuts this year, and the National Association of Realtors (NAR) expects membership rolls to decline this year for the first time in a decade.

.34 To add more fuel to the real estate fire, U.S. home prices are on the decline. In the second quarter of 2007, prices fell at a faster rate than in the first quarter (down 3.2 percent from the same period in 2006), as reported by Standard and Poor's in August 2007. This marked the largest year-over-year decline ever recorded in the 20-year history of the Case-Shiller home price index. The Case-Shiller index, which tracks multiple sales of the same homes, is considered by many observers to be the best gauge of national and metro real estate values. Falling prices make it more difficult for homeowners to tap into their home equity or refinance their mortgages.

.35 The housing crisis has also taken its toll in the multifamily arena. According to the latest results of the Multifamily Condo Market Index, builder confidence in the condominium housing market eroded significantly in the first half of 2007. In many areas, buildings constructed as condos are being turned into rentals because the slow housing market is forcing some owners to rent. In addition, many single family homes are now available for rent, which is also affecting the multifamily market.

.36 In the multifamily rental market, vacancy rates are projected to average 5.8 percent in the fourth quarter of 2007, almost unchanged from 2006. According to NAR, average rent should increase 2.1 percent in 2007 after a 4.1 percent increase in 2006.

.37 In summary, the residential real estate market is in a period of uncertainty, leaving some with the feeling that we have yet to hit bottom. If you have clients involved in the residential market or with significant residential holdings, pay particular attention to the information included in this alert and how these economic and industry conditions may affect your client and your audit. In addition, if you have clients that are also involved in construction, you should consult the Audit Risk Alert *Construction Contractors Industry Developments—2007/08* (product no. 022318kk).

Hospitality Market Conditions

.38 According to Lodging Econometrics (LE), the industry authority for hotel real estate, for the first half of 2007, the total pipeline has grown by 643 projects, which represents a 15 percent increase. Projects under construction and those scheduled to start in the next 12 months are also at cyclical highs. Small imbalances are already visible in some resort locations and in a number of the top 25 markets. For the first 5 months of 2007, 14 of the top 25 markets show supply growth exceeding demand growth. Eleven of those markets also show 2007 room occupancy less than 2006 for the comparable period. LE predicts that when the pipeline begins to unfold this fall, first with smaller mid-market properties, supply and demand imbalances will initially surface at highway and outer suburban locations in smaller cities. Late in 2008, imbalances are likely to appear in the inner suburbs due to an influx of larger, select-service hotels. In addition, 2008 may usher in a number of new mega casino projects, particularly in Las Vegas.

.39 According to Smith Travel Research, a leader in lodging industry tracking and analysis, industry occupancy reached 66.8 percent in the 3 months ending June 2007, up 0.4 percent compared with the second quarter of 2006. The second quarter average room rate gained 5.4 percent to $103.07, and revenue per available room (the combination of occupancy and average room rate and a key industry productivity measure) increased 5.7 percent to $68.90.

REIT

.40 The year 2007 could end up being the first year out of the last eight that REITs do not outperform all other stock groups and indexes. Year-to-date through September 30, 2007, the FTSE National Association of Real Estate Investment Trust (NAREIT) All REIT Index[2] fell by 1.63 percent. Naturally, the mortgage sector has been the hardest hit, posting losses of 41.52 percent year-to-date according to the FTSE NAREIT Mortgage REIT Index. However, some economists seem to think the REIT Index will pick back up in the second half of 2007 and still end up outperforming stocks for the year.

.41 The privatization of REITs is a trend that has continued in 2007. Globally, the United States has seen approximately $1.9 billion in property transactions since 2003. In 2004, privatizations accounted for approximately 2 percent of all transactions; in 2006, that figure rose to 57 percent. One of the largest acquisitions of the year was the purchase of Equity Office Properties Trust by the Blackstone Group for $39 billion. Equity Office Properties Trust was the largest publicly traded owner and manager of office properties in the United States by square footage. Interestingly enough, Blackstone has announced its plans to go public with a $4 billion offering in 2007. This initial public offering would be the first of the major private equity firms to go public. It will be interesting to see if any other private equity firms follow suit. In the past, private equity firms have stayed away from going public due to the additional regulations and disclosures required by the Securities and Exchange Commission (SEC).

Legislative and Regulatory Developments

The Federal Government in Real Estate

.42 In August 2007, the federal government stepped in with a plan to expand federal backing of mortgages in hopes of helping homeowners avoid foreclosure. The bill, which passed the House 348 to 72, would allow the Federal Housing Administration, which insures mortgages for low- and middle-income

[2] The FTSE National Association of Real Estate Investment Trust (NAREIT) All REIT index includes all tax-qualified REITs listed on the New York Stock Exchange, American Stock Exchange, and NASDAQ National Market List.

borrowers, to back refinanced loans for tens of thousands of borrowers who are delinquent on payments because their mortgages are resetting to sharply higher rates from the low initial "teaser" rates mentioned previously in this alert. The measure is Congress' first stand-alone bill in response to the mortgage market crisis. In September, the Senate also passed spending legislation that includes $200 million to provide aid to nonprofits and other groups that offer counseling and information to help homeowners avoid foreclosure.

.43 In September 2007, the Office of Federal Housing Enterprise Oversight, which oversees Fannie Mae and Freddie Mac, agreed to allow both companies to buy more subprime loans, which will result in more loans being available to borrowers and homeowners who are having problems refinancing their mortgage. The NAR President predicts that "with reduced housing prices and increased housing inventory, interest rates that are near historic lows, and now with Fannie's and Freddie's increased ability to lend, we may see positive movement in the housing market."

Audit and Attestation Issues and Developments

Going Concern Considerations

.44 The concept that financial statements are prepared on the basis of a going concern is one of the basis tenants of financial accounting. Some examples of indicators that there could be substantial doubt about the ability of the entity to continue as a going concern would include the following:

- Negative trends such as recurring operating losses, working capital deficiencies, or negative cash flows from operating activities
- Other indications of financial difficulties such as loan covenant violations or denial of usual trade credit from suppliers and denial of surety credit
- Internal matters such as turnover in key positions such as CFO, controller, or other key management or substantial dependence on the success of a particular investment or project
- External matters such as legal matters or an uninsured catastrophe

.45 In addition to these matters, the current uncertain economic situation, especially as it relates to residential real estate, may cause you to have a heightened sense of awareness of a company's ability to continue as a going concern. AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), addresses your responsibilities to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern.

Using the Work of a Specialist

.46 It may be necessary to use a specialist (such as a real estate appraiser) to perform or assist in valuing properties or other audit procedures. 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 paragraph .06 of AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), specialized assistance is advisable for auditors who "may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate audit evidence."

.47 However, use of an outside specialist does not absolve you from a certain level of understanding about the real estate appraiser or other specialist. Use of a specialist must be considered during audit planning because of, among other reasons, the lead time necessary to contract for a specialist's services and the time required for you to obtain the knowledge necessary to supervise the specialist.

.48 The use of a specialist is an excellent way to learn the real estate company's business and can be helpful in initial planning through site visits and fieldwork.

Accounting Issues and Developments

SEC Staff Position on Subprime Loans

.49 In a letter issued on July 24, 2007, the SEC Chairman responded to Congressman Frank's inquiry about the potential impact of Financial Accounting Standards Board (FASB) Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125,* on the mortgagor's ability to make loan modifications to forbear foreclosure. The letter provides the SEC staff position that, "consistent with general agreement in practice, such loan modifications would not result in a requirement for entities to account for those securitized assets on their balance sheets. In this case, modifications undertaken when loan default is reasonably foreseeable should be consistent with the nature of modification activities that would have been permitted if a default had occurred." More specifically, Congressman Frank and other members of Congress asked SEC Chairman Cox to answer the following question.

> *Does FASB Statement No. 140 clearly address whether a loan held in trust can be modified when default is reasonably foreseeable or only once a delinquency or default has already occurred? If not, can it be clarified in a way that will benefit both borrowers and investors?*

.50 In the reply to Congressman Frank, SEC Chairman Cox included an SEC staff memorandum prepared by the SEC's Office of the Chief Accountant that addresses the issue and describes a June 22, 2007, educational forum that the FASB hosted at the request of SEC staff. There was general agreement among participants at the forum that, subject to certain constraints, the ability to restructure mortgages when default is reasonably foreseeable is an activity that is not inconsistent with the notion of continued off-balance sheet accounting treatment. The SEC staff memorandum also provides the staff's current view that additional interpretive guidance is not necessary to clarify the application of FASB Statement No. 140 to the contemplated types of securitized mortgage loan work-out activities.

.51 Congressman Frank's letter of inquiry can be found at www.house.gov/apps/list/press/financialsvcs_dem/061507_frank_letter_to_cox_re_fas_140.pdf, and the SEC response can be accessed on the United States House of Representatives Web site at www.house.gov/apps/list/press/financialsvcs_dem/sec_response072507.pdf.

.52 In response, Senator Schumer wrote a letter addressed to the Big Four auditing firms urging them to advise their clients on the SEC's and FASB's recent guidance on subprime loans. He stressed how serious the damage from this crisis can be and how important it is to find effective solutions. He noted that the number of national foreclosures is up 93 percent from last year, and in certain struggling regional housing markets, "increased foreclosures will put additional downward pressure on housing prices, which if continued, could contribute to severe price declines and disclosures." He cites that while the SEC's and FASB's positions on FASB Statement No. 140 as it applies to loan modifications should now be clear, he is concerned that many of the investors holding securitized mortgage assets are continuing to cite FASB Statement No. 140 as a reason to avoid loan modifications and refinancing. Senator Schumer's letter can be accessed at the Center for Audit Quality (CAQ) Web site at www.thecaq.org/newsroom/pdfs/Schumer_082307.pdf.

Buy-Sell Clauses

.53 In October 2007, the FASB ratified and published for public comment a draft abstract, Emerging Issues Task Force (EITF) Issue No. 07-6, *Accounting for the Sale of Real Estate Subject to the Requirements of FASB Statement No. 66,* Accounting for Sales of Real Estate*, When the Agreement Includes a Buy-Sell Clause*. A buy-sell clause is designed to incorporate into the transaction price the natural tension between the interests of both investors in a buy-sell situation and thereby achieve an acceptable outcome for both investors without protracted negotiations over fair value and the need for binding arbitration to resolve disputes. Furthermore, the buy-sell clause provides investors with an exit strategy for closely held investments. The issue is whether an irrevocable buy-sell clause represents a prohibited form of continuing involvement that would preclude partial sale and profit recognition pursuant to FASB Statement No. 66.

.54 The draft abstract can be found on the FASB Web site at www.fasb.org/eitf/eitfissu.shtml#07-6. Comments were due back by October 22, 2007. Readers should remain alert to developments relative to this exposure draft.

Accounting for Leases

.55 Many have wondered how the new fair value standards issued by the FASB may affect lease accounting. At its September 26, 2007, meeting, the FASB made the following decision related to the impact of FASB Statement No. 157, *Fair Value Measurements,* on leases.

.56 The FASB added a project to its agenda to address issues related to the interaction between FASB Statement No. 13, *Accounting for Leases*, and FASB Statement No. 157. The FASB discussed the initial fair value measurements used for determining lease classification when the lessor is not a manufacturer or dealer and how to apply the fair value measurement objective in FASB Statement No. 157 to estimated residual values. The FASB directed its staff to proceed to a draft of a proposed FASB Staff Position (FSP) for vote by written ballot that would amend the scope of FASB Statement No. 157 to exclude FASB Statement No. 13 and its related interpretive accounting pronouncements. Readers should remain alert to developments.

Recent Auditing and Attestation Pronouncements and Related Guidance

.57 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.58 The Public Company Accounting Oversight Board (PCAOB) establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006	This standard replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit, and also establishes standards and provides guidance on which matters should be communicated, who they

(Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	should be communicated to, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A), to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120) • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	See the "AICPA Risk Assessment Standards" section in this alert.
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50)	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends

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Issue Date: November 2006	the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325.01–.04), which interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.
Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330.01–.06), which interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240)	This PA responds to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive

Revised: June 2007 (Nonauthoritative)	confirmation requests indicating exception, and use of electronic confirmations among other topics.
AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This PA provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditor's report.
PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This standard replaces the PCAOB's previous internal control standard, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements, and, at the same time, eliminate procedures that are unnecessary. Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.
PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting* Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This rule requires a registered public accounting firm that seeks preapproval of an issuer audit client's audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the SEC or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm's independence, and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524. This rule is effective for audits of fiscal years ending on or after November 15, 2007.
PCAOB Conforming Amendments to the Interim Auditing Standards Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)	In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in Appendix 3 of PCAOB Release No. 2007-005A at www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf. These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.

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PCAOB Report, *Report on the Second-Year Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report is based on PCAOB inspections that looked at parts of approximately 275 audits of internal control over financial reporting by registered public accounting firms. Inspections focused on four areas: integrating the audits of financial statements and internal control, using a top-down approach, using the work of others, and assessing risk.
PCAOB Report, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 300—Report on the Initial Implementation of Auditing Standard No. 2") Issue Date: January 2007 (Applicable to audits conducted in accordance with PCAOB standards)	This report focuses on aspects of the PCAOB's interim auditing standards that address the auditor's responsibility with respect to fraud, specifically AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.
PCAOB Staff Questions and Answers, *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees* Issue Date: April 2007 (Applicable to audits conducted in accordance with PCAOB standards)	Topics covered include the following: • The application of Rule 3522(a) when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm • Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction • Whether a registered public accounting firm's independence is affected by the IRS's subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b) • Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself • Clarification of the term *other change in employment event* as it relates to Rule 3522(c)
PCAOB Staff Questions and Answers, *Auditing the Fair Value*	The guidance provides direction for auditing a company's estimation of the fair value of stock

of Share Options Granted to Employees (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, "Section 100—PCAOB Staff Questions and Answers") Issue Date: October 2006 (Applicable to audits conducted in accordance with PCAOB standards)	options granted to employees pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment*, which became applicable for financial statements of companies with fiscal years ending on or after June 15, 2006.

The Auditor's Communication With Those Charged With Governance

.59 In December 2006, the Auditing Standards Board (ASB) issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and is effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to 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. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.60 SAS No. 114 recognizes the importance of effective two-way communication to the audit. It provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires significant matters communicated with those charged with governance to be documented.

Identifying Those Charged With Governance

.61 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those 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.

.62 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.63 Because there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol.

1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.64 In May 2006, the AICPA ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued, the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. However, with the adoption of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, the PCAOB redefined these terms, which now differ from SAS No. 112.

- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.

- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, and identifies indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.

- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.

- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.

- Contains illustrative written communications to management and those charged with governance.

How Revisions of SAS No. 112 Affect Practice

.65 As auditors gain a better understanding of what needs to be communicated to management and those charged with governance, there may be more control deficiencies that are identified as significant deficiencies and material weaknesses and that are then communicated to management and those charged with governance. Auditors may emphasize and therefore spend more time evaluating identified control deficiencies than in the past.

Discussions With Management and Others

.66 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. Auditors may have to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor who does not provide attest services for the client can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.67 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of material weaknesses. Another reason is that auditors have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in written communication as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.68 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented, detected, and corrected by the client.

Issues for Audits of Smaller Entities

.69 One issue that has arisen in audits of smaller entities is the increase in costs as a result of time the auditor spends documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.70 Another issue that has caused concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, detecting, or correcting material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, because doing so would impair independence.[3] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.71 The requirements of SAS No. 112 introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their

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[3] See Ethics Ruling 101-3, "Performance of nonattest services," of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing.

.72 The AICPA has published the AICPA Audit Risk Alert titled *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in implementation of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

AICPA Risk Assessment Standards

.73 In March 2006, the AICPA ASB issued eight SASs referred to as the risk assessment standards (SAS Nos. 104–111). Although the SASs include many of the underlying concepts and detailed performance requirements contained in existing standards, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risks of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between the risks, controls, audit procedures, and conclusions. The risk assessment standards are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier applications permitted. The following table lists the eight SASs and their effects on existing standards.

Statement on Auditing Standards	***Effect on Existing Standards***
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")* (AICPA, *Professional Standards*, vol. 1, AU sec. 230)	This statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230A).
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	This statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A).
SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)	This statement supersedes SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326A).
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)	This statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312A).
SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)	This statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 310), and supersedes SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A).

SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314)	This statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1, AU sec. 318)	This statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)	This statement amends SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350A).

Key Provisions of the Risk Assessment Standards

.74 Whether due to error or fraud, the new risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks that may lead to a material misstatement in the client's financial statements and any mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations of the Treadway Commission's framework, www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs will most likely result in significant changes to firm audit methodologies and the training of personnel. Therefore, it is recommended that auditors allow ample time in advance of the required implementation date. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Companion Audit Guide

.75 In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Audit Documentation Technical Practice Aids

.76 In May 2007, the ASB issued two Technical Practice Aid (TPA) Technical Questions and Answers (TIS) related to SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which was issued in December 2005.

.77 TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.78 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*), discusses whether the provisions of SAS No. 103 related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance*

.79 A key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.80 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date
- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.81 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf. Readers should also note the PITF is currently working on a practice alert that addresses auditing and other considerations related to electronic information that it plans to issue during the third quarter of 2007.

PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*

.82 In May 2007, the PCAOB adopted Auditing Standard No. 5, which was later approved by the SEC on July 25, 2007. This standard replaces Auditing Standard No. 2. Auditing Standard No. 5 is principles-based and presents a risk-based, top-down approach designed to increase the likelihood that material weaknesses will be found before resulting in a material misstatement of a company's financial statements, while eliminating unnecessary procedures. The standard was also designed to make audits more scaleable for smaller or less complex companies. The PCAOB worked closely with the SEC to coordinate Auditing Standard No. 5 with the guidance to public company management that was approved by the SEC in May 2007. Mark Olson, PCAOB Chairman, stated "the new standard is more risk-based and scalable, which will better meet the needs of investors, public companies, and auditors alike."

.83 This new standard is required for all audits of internal control for fiscal years ending on or after November 15, 2007. However, early adoption is permitted and encouraged. For more information, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk).

Recent AICPA Independence and Ethics Pronouncements

.84 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.85 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. 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*.

Recent Accounting Pronouncements and Related Guidance	
FASB Statement No. 159 (February 2007)	*The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
FASB Statement No. 158 (September 2006)	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*
FASB Statement No. 157 (September 2006)	*Fair Value Measurements*
FASB Interpretation No. 48 (June 2006)	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions (FSPs) (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA Statement of Position (SOP) 07-1 (AICPA, *Technical Practice Aids*, ACC sec. 10,930)	*Clarification of the Scope of the Audit and Accounting Guide* Investment Companies *and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies*

(continued)

TIS section 6140.20–.22 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss not-for-profit organizations fund-raising expenses.
TIS section 6931.08–.10 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various employee benefit plan topics.
TIS section 6300.25–.35 (AICPA, *Technical Practice Aids*) (Nonauthoritative)	These questions and answers discuss various issues related to SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts*.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.86 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the real estate 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. The AICPA general *Audit Risk Alert—2007/08* and other AICPA industry-specific alerts also contain summaries of recent pronouncements that may not be discussed here. To obtain copies of AICPA literature, call (888) 777-7077 or go online at www.cpa2biz.com.

Fair Value Measurements

FASB Statement No. 157

.87 In September 2006, the FASB issued FASB Statement No. 157 to provide enhanced guidance for using fair value to measure assets and liabilities. This standard defines fair value and expands disclosures about fair value measurements. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances.

.88 Prior to this statement, there were different definitions of fair value, and guidance for applying those definitions was dispersed among many accounting pronouncements. Difference in the existing guidance created inconsistencies that added to the complexity in applying generally accepted accounting principles (GAAP). FASB Statement No. 157 provides increased consistency and comparability in fair value measurements. Expanded disclosures about the use of fair value to measure assets and liabilities should provide users of financial statements with better information about the use of fair value in the financial statements, the inputs used to develop the measurements, and the effect of the measurements on earnings (or changes in net assets) for the period. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted. Readers can access the full text of FASB Statement No. 157 on the FASB Web site at www.fasb.org.

FASB Statement No. 159

.89 Subsequent to the issuance of FASB Statement No. 157, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159

allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.90 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, provided the entity also elects to apply the provisions of FASB Statement No. 157. The choice to adopt early should be made within 120 days of the beginning of the fiscal year of adoption (for calendar year end entities, by April 2007), provided the entity has not yet issued financial statements, including required notes to those financial statements, for any interim period of the fiscal year of adoption. The FASB and SEC have expressed concern in the way some early adopters have applied the transition provisions of the standard. The AICPA CAQ issued an alert on this development in April 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard such as this is applied in a good faith manner consistent with those objectives and principles. Specifically the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FAS 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed at www.thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

On the Horizon

.91 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to the real estate industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.92 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. 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 in addition to those discussed here. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Auditing Pipeline—Nonissuers

ASB Clarity Project

.93 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB approved for exposure a discussion paper titled *Improving the Clarity of ASB Standards*. This discussion paper seeks feedback on proposed changes to the standards, including:

- Establishing objectives for each of the standards, and the auditor's obligations related to the objectives
- Structural and drafting improvements to make the standards easier to read and understand
- Inclusion, in the explanatory material of the standards, of special considerations related to audits of public entities and small entities
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards

.94 The period to comment ended June 15, 2007. The discussion paper can be accessed at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

Convergence With International Standards

.95 The ASB has created a number of task forces charged with monitoring specific activities of the International Auditing and Assurance Standards Board (IAASB) and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of International Standards on Auditing (ISA). The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.96 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, the ASB previously decided to defer to issuance of a final revised AT section 501 until the

PCAOB issued its amendments and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www.aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles*

.97 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled *Amendment to Statement on Auditing Standards No. 69,* The Meaning of *Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities*. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards titled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA, *Professional Standards*, vol. 1, AU sec. 411]) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www.fasb.org. The ASB will issue its final SAS coincidentally with the FASB's and PCAOB's issuance of their final standards.

Auditing Pipeline—Issuers

.98 Guidance issued by the PCAOB is included in the section of this alert titled "Recent Auditing and Attestation Pronouncements and Related Guidance." For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), mentioned previously.

Accounting Pipeline

.99 Presented below are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year alert have not been finalized as of the date of this writing, and thus are included again.

Business Combinations

.100 Phase one of the business combination project resulted in the issuance of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*. In those statements, the FASB eliminated the use of the pooling of interests method of accounting for business combinations and addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. The objective of phase two of this project is to standardize business combination accounting through the convergence of the FASB and International Accounting Standards Board (IASB) accounting standards and by reconsidering the existing guidance for the purchase method of accounting for business combinations. Among the main proposals are the following:

- All acquisitions of businesses be measured at the fair value of the business acquired.
- Substantially all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date.
- Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations.

.101 In June 2005, the FASB and IASB issued a number of exposure drafts, for which comment periods ended in October 2005. Redeliberations began in January 2006 and were completed in June 2007. The FASB and IASB expect to issue final statements during the fourth quarter of 2007. Four standards are expected to be issued:

- Proposed FASB Statement No. 141(R) and International Financial Reporting Standard (IFRS) No. 3(R), *Business Combinations*
- Proposed FASB Statement No. 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*
- Proposed International Accounting Standard (IAS) Statement No. 27(R)

.102 Readers should remain alert to the final issuances and visit the FASB Web site for further information.

Fair Value

.103 During phase one of the FASB's fair value option project, the FASB issued FASB Statement No. 159, which was previously discussed. In phase two of the project, the FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase two are expected to begin in the third quarter of 2007. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.104 In December 2006, the FASB issued an exposure draft titled *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure ended in March 2007, and the FASB has begun redeliberations to consider significant issues raised by respondents. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133 including how and why an entity uses derivative instruments; how derivative instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entity's financial position, results of operations, and cash flows. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.105 The FASB is working on a project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, to address issues related to the permitted activities of a qualifying special-purpose entity (QSPE), isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, the FASB issued exposure draft, *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During 2007, the FASB expects to address issues related to the permitted activities of a QSPE and then issue another exposure draft during the fourth quarter of 2007 containing potential amendments to FASB Statement No. 140. See the FASB Web site for complete information.

Earnings Per Share

.106 The FASB and IASB have been working together to resolve differences between FASB Statement No. 128, *Earnings per Share*, and IAS Statement No. 33, *Earnings per Share*. This project is part of the larger FASB project, Short-term International Convergence, which has resulted in the issuance of a number of FASB Statements. Currently the FASB and IASB are addressing significant differences that remain relating to instruments that can be settled in cash or shares and are classified as a liability on an entity's balance sheet. The FASB and IASB are considering modifications to the treasury stock method and several scoping issues in which either the FASB or IASB has issued or may issue more detailed implementation guidance on earnings per share that may create a convergence difference. The FASB and IASB are expected to issue an exposure draft for public comment during the third quarter of 2007. This exposure draft will be the third exposure draft the FASB has issued on the earnings per share project. The project and current exposure draft can be reviewed on the FASB Web site.

FASB Codification and Retrieval Project

.107 The goal of this FASB project is to create a single, authoritative codification of U.S. GAAP. The codification will integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, EITF, and the SEC). The codification will have a three layered structure: topic, subtopic, and section. The FASB has structured the topics into three primary areas: overall presentation, transactional (or financial statement account), and industry. The overall presentation area addresses presentation of financial information but does not address items such as recognition, measurement, or derecognition. The transactional or financial statement account area addresses accounting recognition, measurement, or derecognition. The industry area includes guidance unique to the industry. A codification draft is expected in 2007 and will have an extended verification period to ensure that it accurately reflects U.S. GAAP. Once the FASB addresses respondent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards. Readers can track progress of the Codification and Retrieval Project on the FASB Web site at www.fasb.org/project/codification&retrieval_project.shtml.

GAAP Hierarchy

.108 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, which is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonissuers" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.109 ***Proposed FASB EITF Issues.*** Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

.110 ***Proposed FSPs.*** A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

Resource Central

.111 The following are various resources that practitioners engaged in the real estate industry may find beneficial.

Publications

.112 Practitioners may find the following publications useful with respect to the real estate industry:

- Audit and Accounting Guide *Common Interest Realty Associations* (2007) (product no. 012577kk)
- Audit and Accounting Guide *Construction Contractors* (2007) (product no. 012587kk)

- Audit and Accounting Guide *Use of Real Estate Appraisal Information* (1997) (product no. 013159kk)
- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2007) (product no. 012517kk)
- Audit Guide *Audit Sampling* (2007) (product no. 012537kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2007) (product no. 012777kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- Audit Risk Alert *Construction Contractors Industry Developments—2007/08* (product no. 022318kk)
- Audit Risk Alert *Compilation and Review Alert—2007/08* (product no. 022308kk)
- Audit Risk Alert *Independence and Ethics Alert—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Checklist Supplement and Illustrative Financial Statements—Real Estate Ventures* (product no. 008977kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.113 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, TPAs, 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.

Continuing Professional Education

.114 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191 [DVD]). 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.
- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

.115 Among the many courses, *Real Estate Accounting and Auditing* (product no. 730607kk) is specifically related to the real estate industry. This course provides an in-depth study of the unique requirements that apply at each stage of the real estate life cycle.

.116 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.117 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to the real estate industry include the following:

- *Auditing Real Estate Transactions*
- *Accounting for the Impairment of Completed Real Estate Projects*
- *Accounting for the Sale of Real Estate Assets*
- *Introduction to the Real Estate Valuation Process*
- *Planning the Audit of a Real Estate Entity's Financial Statements*
- *Real Estate Accounting and Auditing*

.118 To register or learn more, visit www.cpa2biz.com.

Webcasts

.119 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.120 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.121 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.122 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.123 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. You can reach the Technical Hotline at (877) 242-7212.

Ethics Hotline

.124 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.

Industry Conference

.125 The AICPA sponsors an annual National Real Estate Conference in the fall. The National Real Estate Conference is a two-day conference designed to update attendees on recent developments related to current hot issues in real estate. It is designed to update attendees on recent developments related to real estate accounting and auditing, tax, and management issues. It delivers solid news about the emerging trends in the real estate market while offering new ideas for the accounting and financial management of the real estate industry. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA CAQ

.126 The CAQ (formerly the Center for Public Company Audit Firms) was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.127 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit http://thecaq.aicpa.org.

Industry Web Sites

.128 The Internet covers a vast amount of information that may be valuable to auditors of real estate entities, including current industry trends and developments. Some of the more relevant sites for auditors with real estate clients include those shown in the following table.

Organization	Web Site
Colliers International	www.colliers.com
Grubb & Ellis Company	www.grubb-ellis.com
Hospitality Trends	www.htrends.com
Institute of Real Estate Management	www.irem.org

Organization	**Web Site**
Lodging Econo*metrics*	www.lodging-econometrics.com
National Association of Realtors	www.realtor.org
National Association of Real Estate Investment Trusts	www.nareit.com
National Multi Housing Council	www.nmhc.org
Reis, Inc.	www.reis.com
The Real Estate Roundtable	www.rer.org
Torto Wheaton Research	www.twr.com
Urban Land Institute	www.uli.org

.129 The real estate practices of some of the larger CPA firms may also contain industry-specific auditing and accounting information that is helpful to auditors.

* * * *

.130 This Audit Risk Alert replaces *Real Estate Industry Developments—2006/07*.

.131 The Audit Risk Alert *Real Estate Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's 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 appreciated. You may e-mail these comments to killuzzi@aicpa.org or write to:

Kristy L. Illuzzi, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

.132

Appendix—Additional Web Resource

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org

Web Site Name	*Content*	*Web Site*
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov

[*The next page is 8881*.]

AAM Section 8220

Government Auditing Standards *and Circular A-133 Audits—2007*

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

NOTICE TO READERS
***GOVERNMENT AUDITING STANDARDS* AND CIRCULAR A-133 AUDITS—2007**

This Audit Risk Alert is intended to provide auditors who perform audits under *Government Auditing Standards* or Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, with an overview of recent industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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 relevant to the circumstances of the audit and appropriate. 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.

AICPA Staff

Christopher Cole, CPA CFE
Technical Manager
Accounting and Auditing Publications

Susan Reed
Technical Manager
Accounting and Auditing Publications

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits conducted in accordance with *Government Auditing Standards* (GAS or the Yellow Book) or Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133). Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 It is important that you understand what is happening in the *Government Auditing Standards* and OMB Circular A-133 arena if you perform Yellow Book or Circular A-133 audits. This alert assists you in making considerable strides in gaining an understanding of key developments regarding those audits.

.03 Readers of this alert may also find the AICPA *Audit Risk Alert—2007/08* (product no. 022338kk) useful. Further, if you are also performing a financial statement audit of a state, local government, or not-for-profit organization, you should also refer to the following Audit Risk Alerts:

- AICPA Audit Risk Alert *State and Local Governmental Developments* (2007) (product no. 022437kk)
- AICPA Audit Risk Alert *Not-For-Profit Organizations Industry Developments* (2007) (product no. 022427kk)
- AICPA Audit Risk Alert *Health Care Industry Developments* (2007/08) (product no. 022346kk)

.04 These alerts can be obtained by calling the AICPA at (888) 777-7077 or going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in these alerts.

.05 ***References to Professional Standards.*** When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

Understanding the Entity, Its Federal Programs, and Assessing the Risks of Material Noncompliance

.06 As noted in SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), an auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The Audit Risk Alerts titled, *State and Local Governmental Developments* (2007), *Not-For-Profit Organizations Industry Developments* (2007/08), and *Health Care Industry Developments* (2007/08), further discuss the auditor's responsibilities in this area for a financial statement audit.

.07 In a Circular A-133 audit it is also important to understand the entity subject to single audit and its federal programs, including its internal control over compliance with those programs, to assess the risk of material noncompliance, and to design the nature, timing, and extent of further audit procedures. One of the auditor's initial tasks in the planning process of as single audit is determining whether management has properly defined the entity to be audited. Paragraph 6.11 of the AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits* (GAS/A-133 Guide) provides additional information on defining the entity to be audited, including the option for auditees to meet the requirements of the circular through a series of audits that cover an auditee's departments, agencies, and other organizational units that expended or otherwise administered federal awards during a fiscal year.

.08 Further, Circular A-133 requires the auditee to maintain internal control over compliance for federal programs that provides reasonable assurance that the auditee 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 federal programs. The auditor is required to perform procedures to obtain an understanding of internal control over compliance that is sufficient to plan the audit to support a low assessed level of control risk for major programs. The auditor needs to understand the assertions relevant to the compliance requirements for each major program. In obtaining the understanding, the procedures performed should provide sufficient knowledge of both the design of the relevant controls pertaining to each of the five internal control components (that is, control environment, risk assessment, control activities, information and communication, and monitoring) and whether they have been placed in operation. The auditor ordinarily obtains this knowledge through previous experience with the entity and through such procedures as inquiries of appropriate management, supervisory, or staff personnel; an inspection of the entity's documents and records; and his or her observation of the entity's activities and operations. Chapter 10 of the GAS/A-133 Guide further discusses the auditor's consideration and testing of internal control over compliance for major programs.

.09 Finally, because Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major federal programs, the auditor should assess not only the risk that noncompliance may cause the financial statements to contain a material misstatement, but also the risk that noncompliance may have a material effect on each of its major programs. Chapter 8 of the GAS/A-133 Guide discusses audit risk as it relates to the compliance auditing of major programs.

Industry Developments

.10 From the standpoint of the federal user, audits conducted under Circular A-133 are a key accountability mechanism for the expenditure of taxpayer dollars. Recently, the results of a federal study on single audit quality were issued by the President's Council on Integrity and Efficiency (PCIE) and Executive Council on Integrity and Efficiency. The report titled, *Report on National Single Audit Sampling Project* (the PCIE report), identifies single audit quality deficiencies and shows that improvements are needed. The types of audit quality issues identified in the PCIE report are also consistent with the types of issues found in peer reviews of firms doing single audits and in investigations performed by the AICPA Professional Ethics Division (see "Other Reviews Indicate Continued Problems in GAS and Single Audits" in this alert).

.11 Consequently, as an auditor that performs single audits, you should review the PCIE report in detail to determine if the audit quality deficiencies cited in the report may affect the planning of your future engagements or your current audit methodologies and documentation practices. Further discussion of the results of the federal study is included in, "Results of Federal Study on Single Audit Quality" in this alert.

Legislative and Regulatory Developments

.12 This section sets forth recent changes to relevant regulatory, legislative, and other guidance affecting GAS and Circular A-133 audits. In addition, it provides information on other legislative and regulatory developments.

Results of Federal Study on Single Audit Quality

.13 The long-awaited federal study on the quality of audits performed under OMB Circular A-133 was issued on June 22, 2007. This section presents a background of the study, a summary of findings, a listing of some deficiencies noted, report recommendations, and highlights the AICPA and its Governmental Audit Quality Center's (GAQC) next steps to responding to the report.

.14 *Background.* Several years ago, a group of federal Offices of Inspectors General (OIGs), along with three state auditor's offices, decided to work together to develop a statistically based measure of single audit quality (the Project). The U.S. Department of Education served as the project leader. The project had two primary goals:

- Determine the quality of single audits and establish a statistically based measure of audit quality
- Recommend changes in single audit requirements, standards, and procedures to improve the quality of single audits

.15 To accomplish these goals, the OIGs conducted quality control reviews (QCRs) of a statistical sample of 208 audits randomly selected from approximately 38,000 audits submitted to and accepted by the Federal Audit Clearinghouse (FAC) between April 1, 2003 and March 31, 2004. Generally, the audits reviewed were from the 2002–2003 timeframe and, in some cases, earlier. The sample was split into two strata. Stratum I included audits of entities with $50 million or more of total federal expenditures. Stratum II included audits of entities with at least $500,000 but less than $50 million of total federal expenditures.

.16 The scope of the project covered portions of the single audit relating to the planning, conduct, and reporting of audit work related to the review and testing of internal controls and compliance testing pertaining to compliance requirements for selected major federal programs. Documentation of audit work for up to three major programs for each audit was reviewed. Further, the review included audit work performed on the Schedule of Expenditure of Federal Awards (SEFA) and the content of all of the auditors' reports on the federal programs. The scope did not include a review of the content of, or the audit work performed, related to the general-purpose financial statements, the auditor's opinion on those statements, or the auditors' review of internal control over financial reporting.

.17 *Summary of Findings.* The issues and deficiencies identified in each QCR were compiled, and each engagement was then classified into one of three groupings. The groupings are defined as follows:

- Acceptable: No deficiencies were noted, or one or two insignificant deficiencies were noted. In some cases, the acceptable audits had deficiencies with applicable auditing criteria noted, which did not require corrective action, but should be corrected going forward.
- Limited Reliability: Significant deficiencies with applicable auditing criteria were noted and require corrective action to afford unquestioned reliance upon the entire audit.
- Unacceptable: Deficiencies were so serious that the auditor's opinion on at least one major program cannot be relied upon or a material reporting error was noted requiring that the report be reissued in order to be relied upon by users, or both.

.18 The PCIE report clearly shows that improvements are needed in many areas. The tables shown below summarize the overall results and results by stratum. In addition to providing results by the number of audits reviewed, the OIGs also analyzed the results in relation to the dollar amounts of federal awards reported in the audits reviewed. Results in relation to dollar amounts reported in the audits reviewed show a much higher percentage of acceptability. The following tables show the results for both strata combined and then the results of Stratum I and Stratum II individually.[1]

TOTAL SAMPLE (STRATA I & II)				
	Acceptable	***Limited Reliability***	***Unacceptable***	***Total***
Sampled Audits	115	30	63	208
% of Audits	49%	16%	35%	100%
% of Federal $	93%	2%	5%	100%
STRATUM I (>$50 Million in Federal Expenditures)				
	Acceptable	***Limited Reliability***	***Unacceptable***	***Total***
Sampled Audits	61	12	23	96
% of Audits	64%	12%	24%	100%
% of Federal $	93%	2%	5%	100%

[1] The report indicates the confidence parameter was 90 percent, and the precision parameters ranged between plus or minus 2.1 and 7.9 percentage points.

STRATUM II ($500 Thousand–$50 Million in Federal Expenditures)				
	Acceptable	***Limited Reliability***	***Unacceptable***	***Total***
Sampled Audits	54	18	40	112
% of Audits	48%	16%	36%	100%
% of Federal $	56%	10%	34%	100%

.19 *Deficiencies Identified.* The PCIE report goes into detail regarding the deficiencies noted on the audits reviewed. The following presents a brief summary of deficiencies identified:

- Misreporting of audit coverage of major federal programs
- Unreported audit findings
- Compliance testing not documented as performed or not applicable
- Deficiencies in understanding and testing of internal control over compliance
- Deficiencies in risk assessments as part of major program determination
- Missing audit finding information
- Deficiencies in presentation and auditing of the SEFA
- Management representations related to federal awards missing or misdated
- Consideration of audit materiality at the major federal program level not documented
- Other kinds of deficiencies (described in Appendix A of the report)

.20 *PCIE Report Recommendations.* The PCIE report proposes a three-pronged approach for reducing the deficiencies noted and to improve the quality of single audits. The recommendations in the report are directed to various organizations including the OMB and other federal agencies, the AICPA, and other single audit stakeholders. A summary of the recommendations is as follows:

- Revise and improve single audit criteria, standards, and guidance to address deficiencies noted in the report. Specific recommendations are described throughout Part II and the "Other Matters" sections of the PCIE report and include recommendations for revisions to Circular A-133 and, in some cases, additions or clarifications to AICPA auditing standards and the GAS/A-133 Guide.
- Establish minimum requirements for completing comprehensive single audit training as a prerequisite for conducting such audits (the report suggests at least 16–24 hours) and thereafter, require single audit update training for continued performance of single audits.
- Review and enhance processes to address unacceptable audits and not meeting established training and continuing professional education requirements. This includes (*a*) reviewing the process of suspension and debarment; (*b*) identifying ways that the AICPA and State Boards of Accountancy can further the quality of single audits and address due professional care issues; and (*c*) identifying, reviewing, and evaluating the potential effectiveness of other ways to address unacceptable audits (these other ways could include sanctions to be applied to auditors or fines, or both).

.21 *Next Steps.* The AICPA shares the commitment of the federal agencies involved in the project to improving the quality of single audits. Many of the audits reviewed were performed 4–5 years ago, and the AICPA is hopeful that many endeavors over the last several years (for example, the launch of the GAQC) have already begun to address some of the issues raised in the PCIE report.

.22 However, auditors should take this report very seriously and read the PCIE report in its entirety to determine if the audit quality deficiencies cited in the report may affect the planning of your future engagements or your current audit methodologies and documentation practices.

.23 The AICPA and the GAQC Executive Committee and GAQC staff will be working closely with the federal government on a go-forward basis to address the PCIE report recommendations. During the course of the next year, auditors should watch the GAQC Web site at www.aicpa.org/GAQC for updates on initiatives undertaken by the AICPA and others in response to the PCIE report.

> **Help Desk—**To access the PCIE report go to the following Web site: www.ignet.gov/pande/audit/NatSamProjRptFINAL2.pdf.

Other Reviews Indicate Continued Problems in GAS and Single Audits

.24 In addition to the PCIE report, the GAQC Web site contains a summary of common deficiencies noted in audits conducted in accordance with GAS and Circular A-133 and found during recent peer reviews and AICPA Professional Ethics Division investigations of CPA firms. A sampling of those deficiencies is included below. You should consider reviewing your firm's policies and procedures to determine whether your GAS and Circular A-133 audits might have these types of issues.

- Audit organizations did not submit their peer review report to required parties.
- The engagement team did not meet the *Government Auditing Standards* or state licensing board continuing professional education (CPE) requirements.
- The auditor used inadequate or outdated reference material related to the engagement performed. Be sure to be familiar with new SASs and accounting standards that are issued. Further, you should ensure that you are using the most up-to-date versions of the *Compliance Supplement*, Yellow Book, and the GAS/A-133 Guide.
- The auditor did not use written audit programs or failed to tailor the audit programs for specialized industries or for specific transactions or balances (such as significant inventory and receivable balances).
- Audit documentation did not evidence when appropriate (1) the auditor's consideration of the existence of an internal audit function or the use of service organizations; (2) the auditor's reliance on the work of other auditors or of specialists; (3) the auditor's consideration of the client's internal control structure, the effect of the use of information technology on internal control, or the effect of internal control on substantive procedures; (4) the required communications between predecessor and successor auditors; and (5) adequate or complete documentation regarding engagement planning.
- In Circular A-133 audits, 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. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), provides guidance on the content, retention, and confidentiality of audit documentation as required by generally accepted auditing standards (GAAS). Among other things, AU section 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 AU section 339 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.

- The auditor did not assess the level of materiality or control risk.
- The auditor did not perform or document risk assessments for each of the five components of internal control or at the assertion level for major account balances or transaction classes.
- The auditor did not assess or document the risk of fraud, did not make appropriate inquiries, or did not adequately consider fraud risks in designing audit procedures.
- The auditor did not apply proper sampling techniques.
- Audit documentation did not indicate the disposition of prior audit findings and proper consideration of current potential significant deficiencies and other findings.
- The auditor failed to identify or address the client's incorrect application of generally accepted accounting principles (GAAP) or inadequate financial statement disclosure.
- The auditor did not request a legal representation letter when the client consulted an attorney and, in some cases, did not obtain a client management representation letter or did not include appropriate engagement-specific representations within the letter.
- 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.
- The auditor's reports did not conform to reporting requirements. For example, the reports omitted required wording or did not appropriately address other information accompanying the basic financial statements.
- Not all auditors are including all of the required finding elements in describing their findings for both GAS and Circular A-133 purposes. Among the required elements being left out of findings with respect to Circular A-133 are the Catalog of Federal Domestic Assistance (CFDA) number, federal award number, and year for each federal program. Chapter 5 of *Government Auditing Standards* and section 510(b) of Circular A-133 describes each of the elements that should be included in your findings. You should ensure that each of your findings contain the required elements.
- The auditor failed to audit as major programs type A programs not qualifying as low risk. Circular A-133 requires a type A program to be audited as a major program unless it qualifies as a low-risk program. For a program to be considered low risk, it must, among other criteria, have been audited as a major program in at least one of the two most recent audit periods. Auditors have made errors in applying this criterion. No auditor judgment is permitted in evaluating this historical two-year look-back criterion, and the reason a type A program was not audited in the prior two audit periods is irrelevant. Errors often occurred when a type A program was not audited in the first year it became a type A program (for example, a new program or a program that had previously been type B).
- The auditor failed to audit type A programs as major because of errors made in determining the type A/type B program dollar threshold.
- The auditor failed to audit all programs included in a cluster of programs. *Clusters* are defined in Part 5 of the supplement "Clusters of Programs," and should be considered as one program in determining major programs. Auditors made errors in identifying programs as part of a program cluster.
- The auditor failed 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.
- 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 reports.

- In some cases, the required compliance testing was not performed, sometimes because the auditor did not follow the guidance in Part 7 of the Compliance Supplement titled, "Guidance for Auditing Programs Not Included in This Compliance 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.

Help Desk—The AICPA's GAQC (as discussed in "Governmental Audit Quality Center" in this alert) is the source of the above listing of common engagement deficiencies. Look under the "Resources" tab (gaqc.aicpa.org/Resources/) and select either the "Audits Performed Under *Government Auditing Standards*" or "OMB Circular A-133" links.

Office of Management and Budget Developments

OMB Revises Circular A-133

.25 Auditor reporting required under OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, has been affected by the issuance of SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). On June 26, 2007, the OMB issued a Federal Register Notice titled Revisions to OMB Circular A-133 (the OMB Notice) revising the circular to, among other things, adopt updated terminology consistent with SAS No. 112 requirements.

.26 The OMB Notice has two main purposes: (1) to update the internal control terminology and related definitions used in Circular A-133; and (2) to simplify the auditee reporting package submission requirement to the FAC. With regard to terminology changes, the OMB Notice first states that to be consistent with professional auditing standards, when reporting on *internal control over financial reporting* in a financial statement audit required by Circular A-133, the references to *reportable conditions* and *material weaknesses* in the circular are replaced with the terms *significant deficiency* and *material weakness* as those terms are defined in SAS No. 112 and the 2007 revision to *Government Auditing Standards*. As for the auditor's reporting on internal control over compliance in a single audit, the OMB Notice states that the terms *reportable condition* and *material weakness* are replaced with the updated terminology and definitions in an AICPA Auditing Interpretation of SAS No. 112. These changes are effective for single audits of periods ending on or after December 15, 2006. Further discussion of the AICPA auditing interpretation and related illustrative auditor reports are included in "AICPA Issues Auditing Interpretation to Address SAS No. 112 Implications on Single Audits" in this alert. Further discussion of the 2007 revision to *Government Auditing Standards* is included in "*Government Auditing Standards* Developments" in this alert.

.27 The OMB Notice acknowledges that the change in terminology and related definitions may result in the reporting of additional internal control matters and that the reporting of such additional matters may affect the scope of future single audits, particularly as it relates to the determination of major programs and the auditee's low-risk status.

.28 Further, the OMB Notice also provided instructions on how to address the new internal control terminology in Form SF-SAC, "Data Collection Form for Reporting on Audits of States, Local Governments, and Non-Profit Organizations" (DCF or Data Collection Form) and an important change in the reporting package submission process. See "Data Collection Form and Reporting Package Submission Changes" in this alert for further information on these changes.

Impact on Illustrative Schedule of Findings and Questioned Costs

.29 The illustrative Schedule of Findings and Questioned Costs (Example 12-5 in the GAS/A-133 Guide) should also be modified by auditors to replace the term *reportable condition* throughout the example with the term *significant deficiency* as it is updated in the 2007 edition of the GAS/A-133 Guide.

> **Help Desk—**A PDF of the *Federal Register* notice is available at www.whitehouse.gov/omb/grants/grants_docs.html. As of the date of this alert, OMB has not yet incorporated the changes in the OMB Notice to the version of Circular A-133 on its Web site at www.whitehouse.gov/omb/grants/grants_circulars.html. However, it is expected to do so soon.

OMB Circular A-133 Compliance Supplement Update

.30 The Circular A-133 *Compliance Supplement*, issued annually by OMB, identifies existing important compliance requirements that the federal government expects to be considered as part of an audit required by the Single Audit Act. For the programs it includes, the *Compliance Supplement* provides you with a source of information to understand the federal program's objectives, procedures, and compliance requirements relevant to the audit, as well as the audit objectives and suggested audit procedures for determining compliance with these requirements. For programs not listed in the *Compliance Supplement*, you should follow its Part 7, "Guidance for Auditing Programs Not Included in This Compliance Supplement," which instructs you to use the types of compliance requirements contained in the *Compliance Supplement* as guidance for identifying the types of compliance requirements to test, and to determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.

> **Help Desk—**The 2007 *Compliance Supplement* and two previous years' versions can be found on the OMB Web site at www.whitehouse.gov/omb/grants/grants_circulars.html.

.31 The OMB issued the 2007 *Compliance Supplement* dated March 2007. The 2007 *Compliance Supplement* is effective for audits of fiscal years beginning after June 30, 2006 and supersedes the *Compliance Supplement* issued in April 2006. Appendix V of the supplement, "List of Changes for the 2007 Compliance Supplement," is a key piece of information to identify all of the changes the OMB is making to the supplement.

.32 Some of the more significant changes in the 2007 *Compliance Supplement* include the following:

- New programs were added as follows:
  - — CFDA 14.169, Housing Counseling Assistance Program
  - — CFDA 16.738 replaced 16.579, Byrne Formula Grant
  - — CFDA 20.609, 20.610, 20.611, 20.612, and 20.613 were added to the Highway Safety Cluster
  - — CFDA 84.032 covers the lender portion of 81.032, the Federal Family Education Loans (FFEL) program
- Two programs were deleted as follows:
  - — CFDA 14.854, Public and Indian Housing Drug Elimination
  - — CFDA 16.579 (see CFDA 16.738 above)
- In Part 2, "Matrix of Compliance Requirements," CFDA 10.500 added "subrecipient monitoring," and programs 10.665 and 10.666 removed the "Davis Bacon Act."
- Part 3, "Compliance Requirements," amended references to the various costs principles due to amendments effective in June 2004.

- There were extensive changes made to various programs in Part 4, "Agency Program Requirements."
- In Part 5, various changes were made to the Student Financial Assistance Cluster, including adding two programs, CFDA 84.375, Academic Competitiveness Grant, and CFDA 84.376, National Science and Mathematics Access to Retain Talent Grant. As noted above, five programs were added to the Highway Safety Cluster. Finally, the National Farmworker Jobs Cluster was removed.
- Appendix VI, which discusses special provisions related to Hurricanes Katrina and Rita, was revised.

OMB Clarifies Compliance Supplement Guidance for Research and Development Cluster

.33 If you have clients that participate in federal Research and Development (R&D) programs, you should be aware that the OMB made a correction to the guidance in the 2007 *Compliance Supplement* for the R&D cluster relating to cost transfers after the *Compliance Supplement* had already been issued and posted for several months. The language that appeared in the 2006 *Compliance Supplement* on this topic should have been carried forward to the 2007 *Compliance Supplement.* However, due to an administrative error, it was changed. Upon being notified of the error, OMB corrected the language that originally was included in the 2007 supplement. The revised guidance appears in Part 5, *Clusters of Programs*, in the R&D cluster section on "Allowable Costs/Cost Principles" and reads as follows:

> "Transfers of costs between cost centers or research projects are often used to correct the financial records (such as transfers of costs between projects when costs were initially charged to the wrong project and the institutions control system found the error) and for other valid reasons.
>
> Cost transfers should be reviewed for allowability. A cost transfer from one project to another project may appear to be an unallowable charge to the second project. However, these costs may be allowable costs of the second project because of the closely linked nature of the research, and the costs would be allowable charges to either project. Alternatively, the transfers would not be allowable under the second project if the costs are not allowable under the terms and conditions of that project.
>
> The auditor should determine if journal entries and transfers of costs were made to federal R&D projects. If so, the auditor should select a separate sample of these R&D cost transfers and test the sampled items to determine the allowability of the costs transferred using the applicable federal regulations and award requirements for the project to which the costs were transferred. If the number of cost transfers between unrelated projects is significant, this could be an indication of poor internal control and might result in a noncompliance finding."

.34 If you are auditing R&D clusters as part of your single audits, check the *Compliance Supplement* section that you are using to be sure that the cost transfers guidance is the correct version (that is, that it includes the language above).

OMB Leading Development of Web Site to Provide Data on Grants, Contracts, and Other Spending

.35 OMB has created an interim Web site at www.federalspending.gov to provide data on federal grants, contracts, and other spending in a searchable format. The purpose of this temporary Web site is to solicit feedback from the public on how to develop a search engine for the official Web site, which will be launched in January 2008. This entire effort is geared to satisfying the provisions of the Federal Funding Accountability and Transparency Act, which became law in 2006. Besides providing an opportunity for public comment and feedback, the site offers information and links to the Federal Funding Act (FFA), FFA task force implementation plan, answers to frequently asked questions, and links to information on federal spending.

Federal Audit Clearinghouse Topics

.36 The FAC operates on behalf of the OMB. Its primary purpose is to collect single audit and program-specific audit information and disseminate it to federal agencies and the public. Your clients are responsible for submitting the required reporting packages to the FAC, including the audit reports and the DCF. Auditors are required to complete Part I, Item 7, Part II, and Part III of the form before it is submitted with the reporting package.

.37 Auditors can fill out and print the DCF on the FAC Web site at harvester.census.gov/fac. This site also contains the form's instructions. The FAC encourages online completion and submission because the system provides edit checks that will increase the likelihood that the form will be accepted without errors.

.38 There are separate forms for audits of fiscal periods ending in 2001–2003, and 2004–2006. Submissions covering fiscal periods with end dates before January 1, 2004 should use the prior version of the DCF. As noted in the following section, the 2004–2006 form should be used for audits covering fiscal periods ending in 2004, 2005, 2006, and 2007.

Data Collection Form and Reporting Package Submission Changes

.39 As noted in "Office of Management and Budget Developments" in this alert, the OMB revised Circular A-133 primarily for needed revisions as a result of SAS No. 112. However, the OMB Notice that revised the circular also identified important information and updates relating to the DCF. The OMB Notice states that for single audits of periods ending December 15, 2006 through December 31, 2006, the approved DCF for fiscal years ending 2004, 2005, and 2006 should be used when filing with the FAC. The OMB Notice goes on to say that since the DCF has not yet been updated for the new internal control terminology, any *significant deficiency* should be recorded under the term *reportable condition* on the following items: Part II - items 3 and 4, Part III - items 4 and 5, and Part 3, item 10 (a). The OMB Notice states that the DCF approved for audits with fiscal period end dates in 2004, 2005, and 2006 has now also been extended to apply to audits with fiscal period end dates in 2007. All submissions with fiscal period end dates in 2007 must use the 2004–2006 version of the DCF. The DCF terminology will be updated in an upcoming revision to the form scheduled for January 1, 2008.

.40 The OMB Notice also communicates a change relating to an auditee's submission of the reporting package to the FAC. Per the OMB, due to technology advances, starting January 1, 2007, the auditee is no longer required to submit multiple copies of the reporting package to the FAC, in accordance with Section 320(d) of Circular A-133. Instead, only one copy of the reporting package is necessary. However, Part III, item 8, of the DCF should continue to be completed noting all agencies required to receive a copy of the reporting package.

Data Collection Form and Reporting Package Submission Not Appropriate in Compliance Audits of For-Profits

.41 Some for-profit entities are required by granting agencies through either a grant clause or contract to have a Circular A-133 audit (or an audit that is very similar to a Circular A-133 audit). The FAC has asked that auditors remind their for-profit clients that must undergo such an audit that they are ***not*** to send the DCF and the audit reporting package to the FAC. The package should be sent, however, to the requesting federal or state agency.

Preparing the Data Collection Form

Basic Reporting Requirements

.42 Your client is required to submit both the DCF and one complete copy of the reporting package FAC within 30 days of receipt of the auditor's reports, but no later than nine months after the end of its fiscal year.

The DCF requires information regarding the period under audit, the client, the auditor, a summary of the client's federal expenditures, and a summary of the results of the audit.

.43 To take advantage of the online editing feature, the client is encouraged to use the Internet to enter the DCF data electronically. However, until the FAC receives an acceptable reporting package and the signed DCF, the client does not receive credit for meeting the submission requirement.

.44 The FAC has on its Web site frequently asked questions, which provide additional guidance on completing the form. The FAC also maintains an online database of audit submissions. See the following sections of this alert for additional discussion of the FAC, DCF, and how you can use the FAC database to help lessen the chance that your organization's audits have quality issues.

> **Help Desk**—For questions about submitting the DCF and reporting packages, auditors may contact the FAC by e-mail at govs.fac@census.gov, by phone at (800) 253-0696, or by fax at (301) 457-1592. For questions regarding previous submissions, please call the FAC processing unit at (888) 222-9907.

Data Universal Numbering System Number Questions

.45 The Data Universal Numbering System (DUNS) number field is one area of the 2004–2006 DCF that generates a lot of questions. A DUNS number is a nine-digit identification sequence assigned by Dun & Bradstreet. The instructions to the 2004–2006 DCF state that if your clients are considered to be a direct applicant (that is, the entity that made the grant application to the federal government, including state, local, and tribal governments, and other entities receiving block or other mandatory grants) they are requested to enter their DUNS number(s) for submissions effective starting with submissions for fiscal periods ending in 2005. Questions have arisen as a result of a question and answer that appears in the "Frequently Asked Questions and Answers" document on the FAC's Web site. Question 21 addresses the issue of whether DUNS numbers are required. The answer states that the OMB requests, but does not require, a DUNS number to be entered for all entities submitting a DCF.

Subrecipient Reporting Requirements

.46 The DCF provides information on the results of the Circular A-133 audit and is entered into a database maintained by the FAC. Although both auditors and clients are required to complete parts of the DCF, the client is responsible for submitting both the DCF and the reporting package to the FAC. If your client is a subrecipient, it is also required to forward a copy of a reporting package to the pass-through entity (PTE) when the schedule of findings and questioned costs contains audit findings relating to federal awards provided by the PTE or when the summary schedule of prior audit findings reports the status of any audit findings relating to such awards. If the report contains no such findings, a subrecipient is required only to provide the affected PTEs with a notification that the audit was completed and that neither the schedule of findings and questioned costs nor the summary schedule of prior audit findings contained findings relating to the federal awards provided by the PTE.

Common Reasons for Form Rejection

.47 FAC representatives have identified a number of common faults that would cause the FAC to reject a filing. Most form errors are detected by edits and can be avoided when entering the data on the FAC Web site. Among these are the following:

- Part III, Item 8, "Federal Agency Distribution," is incorrect: A reporting package is distributed to federal agencies only if there are current year findings on directly funded programs, if the program is listed in the Schedule of Prior Year Findings, or they meet the threshold for coverage by a federal cognizant agency not covered by findings on direct funding.

- Part III, Item 9c, "Research and Development," is invalid (either blank or more than one box is checked).
- Part III, Item 9f, "Direct award," is invalid (either blank or more than one box is checked).
- Part III, Item 9a and 9b "CFDA Number," Multiple CFDA Numbers appear on one program line or an extra '.' is included before the CFDA Extension.
- Missing audit components, especially a Corrective Action Plan (when required) from the auditee.
- Missing form signatures or signature dates.

Tips on Reviewing Forms Before Submission

.48 To avoid a DCF rejection, it is important for the form to be carefully reviewed by the auditor prior to its submission. Here are a few tips you can use within your practice to review the DCF before it is submitted to the FAC, and some "red flags" that can raise questions with federal OIGs.

.49 *Part II: Financial Statements.* Part II refers to the financial statement report and the report issued under *Government Auditing Standards*, not the reporting on internal control and compliance relating to federal programs. A tip for the person reviewing Part II is to simultaneously read the final auditor reports and the form to ensure this section is prepared using the final versions of the auditor reports and that the entries on the form are consistent with those reports.

.50 *Part III: Federal Programs.* In reviewing this section of the form, it is good practice to read the instructions to the DCF for Part III. Those instructions include useful information. Again, simultaneously reviewing the final Circular A-133 reporting and the form is good practice to ensure that the entries on the form are consistent with the results of the audit. Other tips for reviewing various items in this part follow.

- Item 7: This should be answered "no" if the summary schedule of prior audit findings indicates there were no prior audit findings.
- Item 8: It is important to ensure that all agencies affected by a cross-cutting finding are included. Also, the line "and, if not marked above, the federal cognizant agency" should not be checked if the client is too small to have a cognizant agency. Finally, it is important that the finding write-ups include all of the required elements, including the CFDA number, to ensure that Item 8 is properly completed.
- For Item 9 in this part, Column B should include the award number when the award does not have a three-digit CFDA extension.
- In Item 9: The programs should be listed in the same level of detail as in the SEFA. For instance, if the SEFA lists 10 Department of Health and Human Services (DHHS) awards within one or more CFDA numbers, Item 9 should list 10 DHHS awards; there should not be one total HHS line.
- Good practice is to prepare a written reconciliation between the total of Item 9(e) to the total of the schedule of federal award expenditures included in the Circular A-133 report. Common reconciling items include amounts that may be reported in the footnotes to the schedule of expenditures of federal awards. The following are examples:
  - — Student loan outstanding balances
  - — Administrative cost allowances
  - — Commodities
  - — Donated property
  - — Interest subsidies
  - — Insurance

- For Item 9, another good practice is for the reviewer to independently verify that Columns C, F, and G have been completed correctly. That is particularly true for very lengthy DCFs, as it is easy to inadvertently mark the wrong box.
- Item 10, Column A, should not include response P ("Other") very often. Sometimes, form preparers will tend to use "P" rather than take the time to properly match a finding to the appropriate compliance requirement. If a "P" is noted as a response, extra attention may be needed to assure that the response is correct.
- Item 10, Column B, "Audit finding reference numbers," should reconcile to Item 8 in Part III, allowing only for differences relating to prior year findings covered in Item 8, but not in Item 10.

Red Flags Raised by Incorrect Data Collection Forms

.51 Federal OIGs sometimes review specific DCF data or use the FAC database to determine potential problems or issues with single audits that have been performed. Once potential problems are identified, the OIGs will likely contact the auditor for additional information or may decide to perform a quality control review of the engagement in question. For this reason, it is even more important that the DCF be completed correctly. The following are some of the red flags that incorrect DCF submissions might raise with federal reviewers:

- If the wrong box is checked in Part II, federal reviewers might conclude that the preparer did not understand the nature of the auditor's report that was issued.
- If the wrong boxes are checked in Part III, Items 1–8, federal reviewers might conclude that the auditor did not understand one or more of the following concepts: low risk auditee, type of report issued, or what belongs on the summary of prior audit findings.
- If Part III, Item 9, is not completed properly, the federal reviewer might conclude that the auditor did not understand the concept of "major programs," or that the auditor audited the incorrect major programs. Further, he or she might conclude that the auditor does not understand the nature of the findings reported.

Revising a Data Collection Form Submission

.52 For one reason or another, your client may need to revise a submission that has been made to the FAC. If this is the case, keep the following in mind:

- You must use a paper copy of the form (available at harvester.census.gov/fac/collect/formoptions.html).
- You should write "Revision" at the top of Page 1 and fill out Page 1 completely.
- You and the client should sign and date the form again.
- The client should fill out corrections/additions/deletions only.
- The client should retotal total federal awards expended (if needed).
- The client should send the paper form to FAC along with a cover letter summarizing the nature of the revision(s).
- The FAC Web site has instructions for such revisions.

Using the FAC Database

.53 You may find it worthwhile to investigate the FAC database. You can find instructions for its use on the FAC Web site at harvester.census.gov/fac. The FAC expects that the major users of its database will be federal sponsoring agencies. A number of agencies report that they have found it useful, for example, to compare the results of their own programmatic audits with those Circular A-133 audits performed by independent auditors and filed on the database. FAC officials also point out that you, as an auditor, can benefit from the database. For example, consider the following benefits:

- You and your clients can check on the status of submissions.
- You and your clients can ascertain the status of their subrecipients' submissions.
- You can perform overall analytical assessments of your organization's audits to determine, for example, whether there are any problems with the two-year look-back rule and major program determination. Although this is true, the FAC should not be the ones making this point.
- You can look at reports or findings related to programs you are auditing to supplement staff training.

Government Auditing Standards Developments

.54 In July 2007, the U.S. Government Accountability Office (GAO) issued the July 2007 revision to *Government Auditing Standards* (GAO-07-731G). The July 2007 revision supersedes the 2003 revision and updates the January 2007 revision. The July 2007 revision contains the final 2007 revisions, including the quality control and peer review sections in Chapter 3, which GAO had exposed for comment in January 2007. The July 2007 revision represents the completed 2007 revision of *Government Auditing Standards* and is the version that should be used until further revisions or updates are made. It will be effective for financial audits and attestation engagements for periods beginning on or after January 1, 2008 and for performance audits beginning on or after January 1, 2008. Early implementation is encouraged. A downloadable version of the complete July 2007 revision is available on the GAO's Yellow Book webpage at www.gao.gov/govaud/ybk01.htm. You will also find ordering information for the printed version on the GAO's Yellow Book webpage at www.gao.gov/govaud/ybk01.htm.

.55 GAO has also issued a summary document titled, *Major Changes: July 2007 Revision to Government Auditing Standards* on its Web site at www.gao.gov/govaud/somc0707.pdf. This document highlights key revisions to the standards including those specifically related to ethics and independence, professional judgment and competence, all types of audits and attestation engagements performed under the Yellow Book, and financial and performance audits. The listing of changes is intended to assist practitioners in updating their related policies and procedures for conducting government audits. Among the significant changes in the July 2007 revision of *Government Auditing Standards* are the following:

Overall Changes

.56 The July 2007 revision accomplished the following:

- Reinforced the key role of auditing in maintaining accountability and providing information for making improvements in government operations
- Clarified the standards through standardized language to define the auditor's level of responsibility and distinguish between auditor requirements and guidance/explanatory material. This approach is consistent with that being used by other auditing standard-setters
- Clarified and expanded the standards to recognize that other sets of professional standards, such as those issued by the Public Company Accounting Oversight Board (PCAOB), the International Auditing and Assurance Standards Board (IAASB), and the Institute of Internal Auditors (IIA) can be used in conjunction with generally accepted government auditing standards (GAGAS)

Changes Related to Ethics and Independence

.57 The July 2007 revision also made changes related to ethics and independence:

- Heightened emphasis on ethical principles as the foundation, discipline, and structure behind the implementation of the standards, including a description of five key ethical principles that guide the work of those who conduct audits in accordance with GAGAS (Chapter 2 is devoted entirely to ethical principles.)
- Clarified and streamlined the discussion of professional services other than audit and attestation engagements (nonaudit services) and their impact on auditor independence by reorganizing the discussion and related examples into three distinct categories of nonaudit services
- Added guidance on actions required if an impairment to independence is identified after the audit report is issued

Changes Related to Professional Judgment and Competence

.58 The July 2007 revision also includes changes related to professional judgment and competence:

- It stressed the critical role of professional judgment in all aspects of GAGAS audits, in considering risk, and in complying with GAGAS overall.
- It expanded the description of competence to emphasize its importance and relate it to key steps in performing an audit and reporting the findings and conclusions.
- It incorporated the revised CPE requirements that were issued by GAO in April 2005 (GAO-05-568G).
- It clarified the CPE requirement to include internal specialists who are part of the audit organization and perform as a member of the team.

Changes Related to Quality Control and Assurance

.59 The July 2007 revision made changes related to quality control and assurance:

- It clarified that an audit organization's noncompliance with the peer review requirements result in a modified GAGAS statement, while the audit organization's compliance (or noncompliance) with the requirements for a system of quality control are tested and reported on as part of the peer review process and do not affect the GAGAS compliance statement.
- It clarified that an audit organization's system of quality control should also provide reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements.
- It clarified that the GAGAS requirements for a system of quality control are consistent with the AICPA proposed Statement on Quality Control Standards (SQCS), except that the GAGAS requirements state that reviews of the work and the report that are performed as part of supervision are not monitoring controls when used alone.
- It added a requirement for an audit organization to include policies and procedures in its system of quality control that collectively address (*a*) leadership responsibilities for quality within the audit organization; (*b*) independence, legal, and ethical requirements; (*c*) initiation, acceptance, and continuance of audit and attestation engagements; (*d*) human resources; (*e*) audit and attestation engagement performance, documentation, and reporting; and (*f*) monitoring of quality.
- It added a requirement for audit organizations to analyze and summarize the results of its monitoring procedures at least annually, with identification of any systemic issues needing improvement, along with recommendations for corrective action.
- It added a requirement for external audit organizations to make peer review reports publicly available and for internal audit organizations to provide a copy to those charged with governance.

Changes Related to All Types of GAGAS Audits and Attestation Engagements

.60 The July 2007 revision also accomplished the following:

- It added guidance on citing GAGAS in the audit report.
- It defined those charged with governance consistent with SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380).
- It added a requirement that the audit organization establish information systems controls concerning accessing and updating electronically maintained audit documentation.
- It clarified reporting requirements for internal control deficiencies, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse.
- It clarified and streamlined several other areas relating to audit and attestation engagements, one of which is requirements and guidance for developing elements of a finding.

Changes Related to Internal Auditors

.61 The July 2007 revision also included the following:

- Several changes to the guidance for internal auditors and encourages internal auditors to use IIA standards in conjunction with GAGAS

Changes Related to Financial Audits

.62 The July 2007 revision further provided the following:

- It updated the financial auditing standards based on recent developments in financial auditing and internal control including SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), and SAS No. 112.
- It clarified that professional judgment is used in determining whether and how to communicate deficiencies in internal control that are not significant deficiencies.
- It added requirements for reporting on the restatement of previously-issued financial statements.
- It encouraged communicating in the audit report significant concerns, uncertainties, or other unusual or catastrophic events that could have a significant impact on the financial condition or operations of a government entity or program for financial audits.

Changes Related to Attestation Engagements

.63 The July 2007 revision made the following changes as they relate to attestation engagements:

- It clarified and revised the description of attestation engagements and included additional examples of types of attestation engagements.
- It conformed attestation engagements standards and guidance for consistency with changes in financial audits.

Changes Related to Performance Audits

.64 The July 2007 revision further provided the following:

- It clarified and revised the definition of performance audits and included additional examples of types of performance audits.

- It enhanced performance auditing standards to elaborate on the overall framework for high-quality performance audits and clarified and expanded information on other performance auditing issues.

Changes Related to Guidance Material

.65 The July 2007 revision also accomplished the following:

- It added an appendix to provide supplemental guidance to assist auditors in the implementation of GAGAS. This guidance does not establish additional GAGAS requirements but is intended to assist auditors in their work.

Effective Dates

.66 As noted above, the 2007 revision is effective for financial statement audits and attestation engagements for periods beginning on or after January 1, 2008 and for performance audits beginning on or after January 1, 2008. Certain standards issued by the AICPA incorporated by reference into the 2007 revision have earlier effective dates. The GAO has indicated that for financial statement audits conducted under *Government Auditing Standards*, the effective dates of those AICPA standards will apply.

.67 The GAO has indicated that until the 2007 revisions become effective, auditors should adopt the terminology and definitions contained in SAS No. 112 when reporting on internal control deficiencies and include in their reports material weaknesses and significant deficiencies. GAO is also encouraging auditors to implement relevant sections of the 2007 revision for financial audits concurrent with the implementation of the related Auditing Standards Board (ASB) standards.

.68 Additionally, GAO states that the 2007 revision should be used in conjunction with the following guidance documents, which are also available on the Yellow Book webpage at www.gao.gov/govaud/ybk01.htm:

- Government Auditing Standards: Answers to Independence Questions (GAO-02-870G, July 2002)
- Government Auditing Standards: Guidance on GAGAS Requirements for Continuing Professional Education (GAO-05-568G, April 2005)

> **Help Desk**—Two examples of the report on internal control over financial reporting and on compliance and other matters using language as defined in SAS No. 112 are available on the GAQC's Web site.

.69 The GAO also plans to issue on its Web site a Professional Requirements Tool. The tool will provide a listing of the professional responsibilities from the 2007 revision that are specifically identified in the standards by the words "must" and "should."

U.S. Department of Housing and Urban Development Update

HUD Consolidated Audit Guide Revisions

.70 The U.S. Department of Housing and Urban Development (HUD) continues its chapter-by-chapter process to update the Consolidated Audit Guide for Audits of HUD Programs, Handbook 2000.04 REV-2 CHG-1 (HUD audit guide). Presented below is a summary of the changes issued through the date of this writing.

Chapter	*Date Issued*	*Effective for Audits With Fiscal Years Ending On or After*
Chapter 2, "Report Requirements and Sample Reports," Example B	March 14, 2007	March 31, 2007
Chapter 2 Example B-1	March 14, 2007	March 31, 2007
Chapter 5, "Insured Development Cost Certification Audit Guidance"	March 23, 2007	June 30, 2007
Chapter 6, "Ginnie Mae Issuers of Mortgage-Backed Securities Audit Guidance"	April 3, 2007	June 30, 2007
Chapter 7, "HUD-Approved Title II"	April 27, 2007	June 30, 2007
Chapter 8, "HUD-Approved Title I"	September 1, 2006	December 31, 2006

.71 Auditors should review the transmittals announcing the issuance of each of the above chapters on the HUD OIG Web site at www.hud.gov/offices/oig/reports/auditguide/ for a summary of the revisions made to each chapter.

.72 The following chapters have yet to be revised or written.

Chapter	*Comment*
Chapter 1, "General Audit Guidance"	Revision in process.
Chapter 2, "Reporting Requirements and Sample Reports" (excluding Example B and B-1 which have already been revised (see table above)	Revision in process.
Chapter 3, "HUD Multifamily Housing Programs"	In the current guide, Chapter 3 is in reserve, and multifamily housing programs are covered in Chapter 4. HUD plans to move the multifamily housing program guidance to Chapter 3. Chapter 3 is in the process of being revised.
Chapter 4	This chapter is reserved to provide guidance on insured hospitals to address the many questions and concerns regularly received from auditors and managers on hospital audits. Development of this chapter has not been started.

.73 Auditors should periodically check HUD's Web site at www.hud.gov/offices/oig/reports/auditguide/ to make certain that they identify and follow the relevant audit guidance. The GAQC Web site will also provide status updates on future HUD revisions to the HUD audit guide.

HUD's Consolidated Audit Guide Incorrectly Used for Circular A-133 Purposes

.74 According to the HUD OIG's office, some auditors have been incorrectly using the HUD audit guide to satisfy OMB Circular A-133 audits requirements of not-for-profit entities participating in Federal Housing Administration (FHA)/HUD's multifamily housing programs. The HUD audit guide is in the process of being updated (see previous section) and is not intended to be a program-specific audit guide that would satisfy Circular A-133 requirements by itself. Although Circular A-133, section 235(a) states that the auditor should contact the OIG to determine whether a current guide exists, HUD reports that no such contacts have been made. HUD indicates that if auditors use the HUD audit guide, it is their responsibility to assure that all Circular A-133 requirements as contained in the Circular and in the *Compliance Supplement* are covered.

Multifamily Audits Where Agents/Owners Manage Multiple Insured Projects

.75 For situations where audit management agents and owners (not-for-profit and for-profit) manage many multifamily insured projects, auditors should be aware that the HUD audit guide is intended to cover the activities of a single project/entity and not the activities of the owner or the management agent. Some auditors have reviewed internal controls of the owner/agent and not of the project. Also, some auditors have not covered compliance requirements of each project but tested requirements of some projects and (1) if acceptable, accepted the results for all projects without disclosure in the projects' audit reports that certain projects were not tested, and (2) if deficiencies were found in the projects tested, those deficiencies were reported only in the tested projects' audit reports and not in all reports that were to be represented by the testing performed. HUD OIG has concluded that insufficient audit work was performed to support the opinion of many of the projects managed by the owner/agent. When HUD completes its revision to Chapter 3 of the HUD audit guide, it will prohibit this type of testing application. However, as part of that revision, HUD is also reviewing areas that can be tested at the owner/agent level if certain operating conditions exist. Also, HUD is reviewing various methods of sampling applications for inclusion in the revision to Chapter 3 to assure that the opinions upon which HUD relies are supportable.

Deficiencies in HUD Audits

.76 In some cases, for-profit organizations, not-for-profits, and public housing authorities (PHAs) and their auditors have not followed the requirements outlined in HUD's *Guidelines on Reporting and Attestation Requirements of Uniform Financial Reporting Standards (UFRS) for Public Housing Authorities, Not-for-Profit Multifamily Program Participants, For-Profit Multifamily Program Participants, and Their Independent Accountants*. This HUD document provides guidance to PHAs and multifamily participants receiving HUD financial assistance and their auditors in meeting HUD audit reporting requirements and requirements for filing financial information electronically with the HUD Real Estate Assessment Center. Specific problems identified include the omission of the required supplemental schedules and omission of required AU section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1), reporting on these schedules.

.77 HUD's settlements with six firms since 2003 reinforce the federal government's strong emphasis on ensuring financial accountability and the importance of firms taking appropriate steps to ensure that they do not have any quality issues. Other steps HUD has taken in this regard include the following:

- Referrals to state boards of accountancy and the AICPA
- New methods of audit verification (that is, HUD staff reperforms a portion of the Circular A-133 audit at PHAs to determine whether the PHAs' audit firms identified all material instances of noncompliance with federal laws, regulations, and contract provisions occurring at the agency.)

Other Regulatory Activity

USDA Rural Rental Housing and Rural Labor Housing Programs

.78 The USDA Office of Rural Development (RD) recently issued a letter to its state directors informing them that the financial reporting and audit requirements for the Rural Rental Housing (RRH) Program and the Rural Labor Housing (RLH) Program are changing effective for projects with December 31, 2007 year-ends. You can access the letter issued August 29, 2007, at the following Web site: www.rurdev.usda.gov/regs/ul/ulaugust07.pdf. If your firm has clients that participate in these programs, you should pay close attention to the new requirements.

.79 Those firms having clients that participate in the previously described programs know that it was not that long ago that the USDA Office of Inspector General (OIG) issued audit guidance titled, *Audit Program, USDA Rural Rental Housing Program*, which can be accessed at www.usda.gov/oig/webdocs/FINALAUDPROG050414.pdf, that deleted the financial statement audit requirement and, instead, required an agreed-upon procedures engagement for the RRH program. For that reason, the GAQC staff verified the authoritative status of the new USDA RD audit guidance with the USDA OIG. The OIG stated that although it has not approved or sanctioned the new guidance, they will not impede its implementation at this time. Therefore, you should use the new guidance in lieu of the previous RRH Audit Program. However, you should also note that the OIG cautioned that the guidance in the previously issued Audit Program for Construction Cost Engagements continues to be effective.

.80 Among other things, the new RD guidance will reinstate a financial statement audit requirement to be performed under *Government Auditing Standards* for borrowers with projects of 24 or more units. Further, borrowers with projects of 16 units or more will be required to undergo an additional agreed-upon procedures engagement. The RD guidance identifies three agreed-upon procedures that must be performed and promises additional guidance on testing criteria and procedures, sampling methodology and sample size, and standard reporting requirements. Borrowers with projects of 15 or fewer units are not subject to either the financial statement audit or agreed-upon procedures requirement. Finally, all borrowers will have additional reporting requirements directly to USDA (for example, borrower certification of performance standards). The following table (which is excerpted from the guidance) summarizes the new requirements:

Rural Development MFH Year End Financial Reporting Requirements				
Type of Property	***Forms RD 3560-7 and 3560-10?***	***Borrower Certification of Performance Standards?***	***Agreed-Upon Procedures and Determinations****	***Audited Financial Statements? (In Accordance With Yellow Book Standards)***
Rural Development Project (1–15 units)	Yes	Yes	No	No
Rural Development Project (16–23 units)	Yes	Yes	Yes	No
Rural Development Project (24+ units)	Yes	Yes	Yes	Yes*
State and local governments, Indian tribes, and Non-profit Organizations (subject to OMB Circular A-133)	Yes	Yes	No	No**

* Must be completed by a CPA.

** This Audit is in Accordance with OMB Circular A-133 and submitted to the Agency as **part** of the Financial Reporting Requirements.

.81 The guidance also provides several examples to further illustrate the above requirements as follows:

- A project of 36 units owned by a limited partnership must provide the self-certification, the budget and balance sheet forms, the agreed-upon procedures, and the financial audit.
- A for-profit borrower with an 8-unit project must provide the self-certification and the two forms.
- A for-profit borrower with a 20-unit property will provide the self-certification, the two forms, and the agreed-upon procedures.
- A nonprofit housing authority, subject to OMB Circular A-133, with a 24-unit property, will provide a copy of that report, the self-certification, and the two forms.
- A nonprofit borrower not subject to A-133 with a 16-unit property will provide the self-certification, the two forms, and the agreed-upon procedures.

.82 You should periodically check the RD "regulations" section of the USDA Web site for updates at www.rurdev.usda.gov/regs/.

Department of Education Amends Student Financial Assistance Guide to Reflect Two New Programs

.83 If your firm audits for-profit postsecondary institutions or servicers, you should be aware that in September, the U.S. Department of Education (ED) issued interim guidance to amend the January 2000 Audit Guide *Audits of Federal Student Financial Assistance Programs at Participating Institutions and Institution Servicers* (SFA Guide). The guide can be found at www.ed.gov/about/offices/list/oig/nonfed/sfgd2000.pdf. The purpose of the guidance is to recognize two new financial aid programs—the Academic Competitiveness Grant (ACG) Program and the National Science and Mathematics Access to Retain Talent Grant (National SMART Grant) Program.

.84 The guidance was issued in the form of a "Dear CPA Letter" and can be accessed at www.ed.gov/about/offices/list/oig/nonfed/dearcpa0701.pdf. ED issued the guidance in this interim format because it is in the process of working on a more comprehensive revision to the SFA Guide to reflect changes in the Federal Student Aid programs. In the meantime, ED wants to ensure audit coverage of the ACG Program and the National SMART Grant Program before the complete revised SFA Guide is issued.

.85 The ED guidance provides background information on each of the new programs. It also includes required procedures for each program that are mandatory for all audits conducted using the SFA Guide for audits with field work starting on or after (or still being conducted) 15 calendar days after the date of the issuance of the amendment (that is, 15 calendar days after issuance date of August 30, 2007), if the client institution participated, or should have participated, in either of the new programs in audit periods ending after June 30, 2006. Two of the required procedures are also applicable for audits of servicers who service schools participating in the two new programs.

.86 Watch the GAQC Web site for updates and information on the more comprehensive revision to the SFA Guide.

Recent Auditing and Attestation Pronouncements and Related Guidance

.87 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. 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 audit portion of the single audit. You can look to the Audit Risk Alerts *State and Local Governmental Developments* (2007), *Not-For-Profit Organizations Industry Developments* (2007/08), and *Health Care Industry Developments* (2007/08) for further discussion of the financial statement audit implications of these standards. We are only describing in more detail below those standards that may have some impact on your single audits.

.88 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/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. The GAQC Web site at www.aicpa.org/GAQC is also a useful Web site to look for updates. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for periods beginning on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards*, vol. 1) Issue Date: November 2006 (Applicable to audits conducted in accordance with GAAS)	This standard does the following: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A), to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 120) • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks • Replaces throughout the SASs the term *completion of fieldwork* with the term *date of the auditor's report* • Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report

(continued)

SAS Nos. 104–111, the risk assessment standards Issue Date: March 2006 (Applicable to audits conducted in accordance with GAAS)	See "AICPA Risk Assessment Standards" in this alert.
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) Issue date: May 2006 (Applicable to audits conducted in accordance with GAAS)	This standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) Issue date: December 2005	SAS No. 103 supersedes SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339) and amends AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1). Effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted, this SAS establishes standards and provides guidance to an auditor of a nonissuer on audit documentation.
Statement on Standards for Attestation Engagements (SSAE) No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards*, vol. 1, AT sec. 50) Issue Date: November 2006	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 20). It is effective for periods ending on or after December 15, 2006.
Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1, AU sec. 9325.01–.04), which interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1) Issue Date: July 2007 (Interpretive publication)	This auditing interpretation interprets AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), and addresses how the definitions of the terms *control deficiency*, *significant deficiency*, and *material weakness* should be adapted and applied in the context of reporting on internal control over compliance in a single audit.

Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, *Professional Standards*, vol. 1, AU sec. 9330.01–.06), which interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1) Issue Date: March 2007 (Interpretive publication)	This auditing interpretation interprets AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, vol. 1), and addresses the issue of electronic confirmations.
AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.
AICPA TPA TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*) Issue Date: May 2007 (Nonauthoritative)	This question and answer discusses whether the provisions of SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.
AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, *Audit Confirmations* (AICPA, *Technical Practice Aids*, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)	This practice alert responds to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.
AICPA PITF PA 07-1, *Dating of the Auditor's Report and Related Practical Guidance* (AICPA, *Technical Practice Aids*, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)	This practice alert provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditor's report.

The Auditor's Communication With Those Charged With Governance

.89 In December 2006, the ASB issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and is effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to 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. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.90 SAS No. 114 recognizes the importance of effective two-way communication to the audit. It provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires significant matters communicated with those charged with governance to be documented.

Identifying Those Charged With Governance

.91 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those 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.

.92 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.93 Since there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. Examples for state and local governmental entities might include governing boards, city councils, audit committees, mayors, governors, legislators, university/college presidents, and chancellors. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.94 In May 2006, the AICPA ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. The new SAS is applicable

whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.
- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, as well as indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.
- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.
- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the *report release date*.
- Contains illustrative written communications to management and those charged with governance.

.95 The AICPA has also published the AICPA Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in implementation of this SAS in a financial statement audit. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

> **Help Desk—**The GAQC has provided a public link on its Web site to an archived conference call discussing SAS No. 112 and its impact on practice. You can find the link to the call at gaqc.aicpa.org/Resources/Impact+of+SAS+112+on+Governmental+Financial+Audits+Conference+Call.htm.

AICPA Issues Illustrative Yellow Book Reports With SAS No. 112 Terminology

.96 The required *Government Auditing Standards* reporting is also affected by the issuance of SAS No. 112. As noted by GAO upon issuance of the 2007 revision to the Yellow Book, auditors should adopt the terminology and definitions in SAS No. 112 when reporting on internal control deficiencies (see also, "*Government Auditing Standards* Developments" in this alert). The GAQC has developed updated Yellow Book report illustrations that reflect the new SAS No. 112 terminology that can be found at gaqc.aicpa.org/Resources/Illustrative+Auditors+Reports/#YB. Those reports have been reviewed by GAO staff. The illustrative report examples, which update two illustrations that appear in the GAS/A-133 Guide, will ultimately be incorporated into the 2007 edition of the GAS/A-133 Guide when it is updated later this year. Further, two other reports in the GAS/A-133 Guide (Example 4-4 and 4-6) will be updated in the 2007 edition to reflect similar SAS No. 112.

AICPA Issues Auditing Interpretation to Address SAS No. 112 Implications on Single Audits

.97 The ASB has issued a final related audit interpretation to SAS No. 112 (AU section 9325.01–.03) titled, Auditing Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, *Professional Standards*, vol. 1). As mentioned previously in "OMB Revises Circular A-133," in this alert, the issuance of this interpretation coincides with the issuance by OMB of a revision to Circular A-133 for the implications of SAS No. 112. The interpretation establishes definitions for the terms *control deficiency*, *significant deficiency*, and *material weakness* when the auditor is reporting control deficiencies that relate to internal control over compliance in a Circular A-133 audit. The terms and definitions included in the interpretation are as follows:

- A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect on a timely basis noncompliance with a type of compliance requirement of a federal program.
- A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to administer a federal program such that there is more than a remote likelihood that noncompliance with a type of compliance requirement of a federal program that is more than inconsequential will not be prevented or detected.
- A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance with a type of compliance requirement of a federal program will not be prevented or detected.

Updated Circular A-133 Illustrative Single Audit Reports Issued to Incorporate SAS No. 112 Language

.98 The three Circular A-133 reports listed below have been updated for SAS No. 112 and are incorporated into the 2007 update to the GAS/A-133 Guide which is expected to be available in late 2007. GAS/A-133 Guide also includes other illustrative reports illustrating various compliance reporting situations that were also updated for SAS No. 112.

- Example 12-1. 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 Significant Deficiencies in Internal Control Over Compliance Identified*]).
- Example 12-2. 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 Significant Deficiencies in Internal Control Over Compliance Identified*) [Note that this is a new report to reflect the most common situation for the reporting of significant deficiencies—that is, when the report on compliance is unqualified].
- Example 12-3. 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 Material Weaknesses in Internal Control Over Compliance Identified*) [Note that this report has been revised to reflect the most common situation for the reporting of material weaknesses—that is, when the report on compliance is qualified].

  Help Desk—The GAQC has provided updated illustrative single audit reports that incorporate the new SAS No. 112 language on its Web site at gaqc.aicpa.org/Resources/Illustrative+Auditors+Reports/#OMB

Guidance on Evaluating Control Deficiencies in a Single Audit

.99 As noted in SAS No. 112, the auditor must evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses. However, the guidance in SAS No. 112 for evaluating control deficiencies is written from the perspective of a financial statement audit. The following guidance is intended to emulate the guidance in SAS No. 112 for your consideration when evaluating control deficiencies in a single audit.

.100 In a single audit, the significance of a control deficiency depends on the potential for noncompliance, not on whether noncompliance actually has occurred. Accordingly, the absence of identified noncompliance does not provide evidence that identified control deficiencies are not significant deficiencies or material weaknesses. When evaluating whether control deficiencies, individually or in combination, are significant deficiencies or material weaknesses, the auditor should consider the likelihood and magnitude of actual or potential noncompliance.

.101 The following are examples of factors that may affect the likelihood that a control, or combination of controls, could fail to prevent or detect noncompliance:

- The nature of the type of compliance requirement involved. For example, a specific special test or provision may involve greater risk because it is unique to the program and may require unique controls.
- The susceptibility of the program and related types of compliance requirements to fraud.
- The subjectivity and complexity involved in meeting the compliance requirement and the extent of judgment allowed.
- The cause and frequency of any known or detected exceptions related to the operating effectiveness of a control.
- The interaction or relationship of the control with other controls.
- The interaction of the control deficiency with other control deficiencies.
- The possible future consequences of the deficiency.

.102 The evaluation of control deficiencies includes the magnitude of noncompliance. Several factors affect the magnitude of noncompliance that could result from a deficiency or deficiencies in controls. The factors may include, but are not limited to, the following:

- The program amounts or total of transactions exposed to the deficiency in relation to the type of compliance requirement
- The volume of activity related to the compliance requirement exposed to the deficiency in the current period or expected in future periods
- Adverse publicity or other qualitative factors

.103 Multiple control deficiencies that affect the same type of compliance requirement increase the likelihood of noncompliance and may, in combination, constitute a significant deficiency or material weakness, even though such deficiencies are individually insignificant. Therefore, the auditor should evaluate individual control deficiencies that affect the type of compliance requirement, or component of internal control, to determine whether they collectively result in a significant deficiency or material weakness.

.104 In determining whether a control deficiency or combination of control deficiencies is a significant deficiency or material weakness, the auditor also should evaluate the possible mitigating effects of effective compensating controls that have been tested and evaluated as part of the audit of the major program. A compensating control is a control that limits the severity of a control deficiency and prevents it from rising to the level of a significant deficiency or, in some cases, a material weakness. Compensating controls operate at a level of precision, considering the possibility of further undetected noncompliance, which would result in the prevention or detection of noncompliance that is more than inconsequential or material to the type of compliance requirement. Although compensating controls mitigate the effects of a control deficiency, they do not eliminate the control deficiency. The auditor could evaluate and test the effectiveness of a compensating control and determine whether it operates effectively for the purpose of mitigating the effects of the control deficiency in the type of compliance requirement.

.105 The auditor may encounter deviations in the operating effectiveness of controls. A control that has an observed nonnegligible deviation rate is at least a control deficiency regardless of the reason for the deviation, and could be, based upon further evaluation, a significant deficiency or material weakness. For example, if the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

.106 The auditor should conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency. Although the term *prudent official* is not defined in the standard, the concept is that an auditor should "stand back" and take another objective look at the severity of the deficiency much as would a regulator or someone from an oversight agency.

.107 For purposes of deficiencies in a single audit, the following areas ordinarily are at least significant deficiencies in internal control:

- Policies and procedures that are incomplete, inadequate, or outdated for the activities subject to a type of compliance requirement.
- Inadequate segregation of duties over a type of compliance requirement.
- Controls over complex types of compliance requirements.
- IT controls relating to the activity subject to the type of compliance requirement.

.108 Each of the following is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- Lack of operating policies and procedures for the activities subject to a type of compliance requirement.
- Ineffective oversight of a major federal program by those charged with governance over compliance with those program requirements where the activity is subject to the type of compliance requirement, for example, lack of adequate review of federal financial reports prior to submission to the grantor.
- Identification by the auditor of material noncompliance for the period under audit that was not initially identified by the entity's internal control. (This is a strong indicator of a material weakness even if management subsequently corrects the noncompliance.)
- An ineffective internal audit function or risk assessment function for a major program for which such functions are important to the monitoring or risk assessment component of internal control for a type of compliance requirement.
- Identification of fraud in the major program of any magnitude on the part of senior program management. For the purposes of evaluating and communicating deficiencies in internal control, the auditor should evaluate fraud of any magnitude—including fraud resulting in immaterial noncompliance—on the part of senior program management, of which he or she is aware.
- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected.
- An ineffective control environment. Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment over compliance with major program requirements.

AICPA Risk Assessment Standards

.109 In March 2006, the AICPA ASB issued eight SASs referred to as the risk assessment standards (SAS Nos. 104–111) that are described in the following table. They are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier applications permitted. The risk assessment standards were written from the perspective of a financial statement audit. The AICPA will be evaluating the new SASs and any potential implications for audits performed under Circular A-133. Watch the GAQC Web site for further updates over the course of the next year.

Statement on Auditing Standards	*Effect on Existing Standards*
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1*, Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")* (AICPA, *Professional Standards*, vol. 1, AU sec. 230)	This statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AICPA, *Professional Standards*, vol. 1, AU sec. 230A).
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards (AICPA, *Professional Standards*, vol. 1, AU sec. 150)	This statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150A).
SAS No. 106, *Audit Evidence* (AICPA, *Professional Standards*, vol. 1, AU sec. 326)	This statement supersedes SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326A).
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312)	This statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312A).
SAS No. 108, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311)	This statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AICPA, *Professional Standards*, AU sec. 310), and supersedes SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311A).
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314)	This statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*, vol. 1, AU sec. 318)	This statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319).
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling (AICPA, *Professional Standards*, vol. 1, AU sec. 350)	This statement amends SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350A).

Audit Documentation

.110 SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), provides guidance on the form, content, retention, extent, and confidentiality of audit documentation as required by

GAAS. Among other things, SAS No. 103 requires audit documentation to be sufficient to enable an experienced auditor, having no previous connection to the audit, to understand the nature, timing, extent, results, and conclusions of auditing procedures performed, and that the accounting records agree or reconcile with the audited financial statements or other audited financial information. SAS No. 103 contains guidance on documenting significant findings or issues; identifying the preparer and reviewer of audit documentation; documenting specific items tested; documenting departures from relevant SASs; revising audit documentation after the date of the auditor's report; and ownership and confidentiality of audit documentation.

.111 It requires you to assemble, within 60 days following the delivery of the auditor's report to the entity, the audit documentation that forms the final audit engagement file. (Some states may require that this be done within a shorter period.) After that date, SAS No. 103 precludes you from deleting or discarding existing audit documentation, and requires that you appropriately document any subsequent additions or changes.

.112 In developing this SAS, the ASB considered the documentation requirements of the PCAOB, the International Auditing and Assurance Standards Board, the GAO's *Government Auditing Standards*, and suggestions received from the National Association of State Boards of Accountancy. The SAS establishes standards and provides guidance to an auditor of a nonissuer regarding the audit documentation for audits of financial statements or other financial information being reported on. Audit reviewers consider audit documentation to be an essential element of determining audit quality, including the quality of audits conducted under GAS and Circular A-133. Evidence from quality control reviews and peer reviews clearly shows that problems with audit documentation may be the root of many quality problems. Therefore, you may want to consider spending some time considering the new requirements and your firm's policies and procedures relating to documentation. Some additional key areas of the SAS are as follows:

- It requires the auditor, when preparing audit documentation, to consider the needs of an "experienced auditor" having no previous connection with the audit, to understand the procedures performed, the evidence obtained, and the specific conclusions reached. That concept is likely to be familiar to you because GAS contains a similar requirement.
- It provides enhanced guidance concerning matters that should be documented and the retention of documentation.
- It requires you to document audit evidence that is contradictory or inconsistent with the final conclusions and how you addressed the contradiction or inconsistency.

.113 We suggest that you consider this requirement as you develop your firm internal policies with regard to documentation. You should keep in mind that, in situations in which a single audit is performed later, after the completion of the financial statement audit, questions have arisen about how the 60-day requirement would apply to single audit documentation. While no authoritative guidance has been issued on this question yet, some are interpreting this to mean that the auditor would assemble, within 60 days following the delivery of the auditor's Circular A-133 report to the entity, the single audit documentation that forms the final single audit engagement file.

.114 It specifies a minimum file retention period of five years from the date of the auditor's report. Some states have their own separate retention requirements that may extend beyond five years for auditors that practice within the state. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2006.

Dating the Auditor's Reports

.115 SAS No. 103 also includes amendments to SAS No. 1, section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530.01 and .05). The amendment requires that your report not be dated earlier than the date on which you have obtained sufficient competent audit evidence to support the opinion on the financial statements.

.116 The AICPA has issued Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance*, providing information that may help practitioners interpret this requirement. See the discussion in the next section of this alert.

.117 The auditor's report on compliance and on internal control over compliance related to major programs, as required by Circular A-133, ordinarily should have the same date as that of the other reports, but may carry a later date because some of the audit work to satisfy Circular A-133 requirements may be done subsequent to the work on the financial statements. When this is the case, the reporting required by Circular A-133 should be dated at the later date (that is, when the auditor has obtained sufficient appropriate audit evidence to support the report on the audit of compliance).

Audit Documentation Technical Practice Aids

.118 In May 2007, the ASB issued two practice aids related to SAS No. 103, which was issued in December 2005.

.119 Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*) discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because, since management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.120 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*), discusses whether the provisions of SAS No. 103 related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Practice Alert No. 07-1, *Dating of the Auditor's Report and Related Practical Guidance*

.121 A key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.122 The Professional Issues Task Force (PITF) issued Practice Alert No. 07–1 to provide guidance to auditors of nonissuers regarding the following:

- The audit report date

- Evidence supporting financial statement amounts and disclosures—specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.123 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf. Readers should also note the PITF is currently working on a practice alert that addresses auditing and other considerations related to electronic information which it plans to issue during the third quarter of 2007.

AICPA Peer Review Checklists—A Tool to Help Improve Audit Quality

.124 In performing peer reviews, review teams must complete all relevant programs and checklists issued by the AICPA Peer Review Board. The AICPA updates its *Peer Review Checklists* annually; the 2007 versions of those checklists (which include checklists on state and local government, health care, and not-for-profit audits; GAS audits; single audits; and HUD audits) are now available. While intended for use in peer reviews, the various relevant checklists may be a helpful tool for your firm or audit organization to use as a memory jogger to ensure you have not overlooked anything significant before issuing your audit reports. Taking this step may help you improve your audit quality. The various relevant checklists can be accessed through the GAQC at gaqc.aicpa.org/Resources/Research+Tools+and+Aids/Peer+Review+Checklists.htm.

Recent AICPA Independence and Ethics Pronouncements

.125 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Independence Requirements Under AICPA Rules, GAS, and Circular A-133

.126 If you perform audits under GAS (including Circular A-133 audits), then you should be aware of the independence rules in those standards and regulations, as well as the independence rules of the AICPA. The AICPA's Professional Ethics Executive Committee (PEEC) proposes and issues ethics interpretations and rulings relating to independence and other ethics matters. You can download recent proposals and rulings from the AICPA Web site at www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/.

.127 In a GAAS audit, AICPA members are required to comply with the AICPA's Code of Professional Conduct Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.01). Ethics Interpretation 101-3, "Performance of Nonattest Services" (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05), establishes requirements that members should meet to perform nonattest services for an attest client without impairing independence with regard to that client.

> **Help Desk**—In July 2006, the AICPA published a Practice Aid, *Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Requirements* (product no. 006627kk). This valuable tool contains a series of checklists to help auditors determine their compliance with applicable independence rules. The publication can be obtained at www.cpa2biz.com or by calling the AICPA at (888) 777-7077.

.128 For audits conducted in accordance with GAS, auditors and audit organizations also are subject to the GAS independence rules. Those rules, which are, in some cases, very similar to the AICPA independence rules and in other cases more restrictive, address when auditors and their organizations are independent from the organizations they audit by defining when personal, external, and organizational impairments to independence exist.

.129 To comply with the GAS provisions governing nonaudit services to audit clients, audit organizations are required to meet two overarching principles. First, audit organizations are barred from performing management functions or making management decisions for their clients. Second, audit organizations are prohibited from auditing their own work or providing nonaudit services if the services are material or significant to the subject matter of the audit. Paragraphs 3.24–.30 of GAS discuss various types of nonaudit services and the affect that they have on auditor independence. The GAO has issued a question and answer document, *Answers to Independence Standard Questions*, to address its independence standard.

> **Help Desk—***Answers to Independence Standard Questions* is available on the Web at www.gao.gov/govaud/ybk01.htm. The AICPA Web site provides a useful discussion of the AICPA and GAO independence rules at www.aicpa.org/audcommctr/spotlight/Govt_21_Independence_and_Related_Topics.htm.

.130 Finally, you should note that Section 305(b) of Circular A-133 contains an additional independence requirement. Under Circular A-133, an auditor who prepares the indirect cost proposal or cost allocation plan may not also perform the single audit when indirect costs recovered by the auditee during the prior year, as defined, exceeded $1 million.

On the Horizon

.131 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to *Government Auditing Standards* or Circular A-133 audits or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.132 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. 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 in addition to those discussed here. 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/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+ Standards/Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code +of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

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 service@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. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Auditing Pipeline

ASB Clarity Project

.133 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB approved for exposure a discussion paper, *Improving the Clarity of ASB Standards*. This discussion paper seeks feedback on proposed changes to the standards, including the following:

- Establishing objectives for each of the standards and the auditor's obligations related to the objectives
- Structural and drafting improvements to make the standards easier to read and understand
- Inclusion, in the explanatory material of the standards, of special considerations related to audits of public entities and small entities
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards

.134 The period to comment ended June 15, 2007. The discussion paper can be accessed at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

Convergence With International Standards

.135 The ASB has created a number of task forces charged with monitoring specific activities of the IAASB and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of International Standards on Auditing (ISA). The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Response to Single Audit Quality Issues

.136 With the increased focus on single audit quality (see "Results of Federal Study on Single Audit Quality" in this alert), there are likely to be many new projects taken on over the course of the next year and into the future to address the audit deficiencies cited in the PCIE report. These projects could result in revisions to AU section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1), the GAS/A-133 Guide, and other standards, regulations, and guidance. The best way to keep informed of developments over the next year is to watch the GAQC Web site at www.aicpa.org/GAQC for updates and news items.

Resource Central

.137 The following are various resources that practitioners engaged in *Government Auditing Standards* and Circular A-133 audits may find beneficial.

Publications

.138 Practitioners may find the following publications useful with respect to *Government Auditing Standards* and Circular A-133 audits.

- Audit Guide Government Auditing Standards *and Circular A-133 Audits* (2007) (product no. 012747kk)
- Audit and Accounting Guide *State and Local Governments* (2007) (product no. 012667kk)
- Audit and Accounting Guide *Not-for-Profit Organizations* (2007) (product no. 012647kk)
- Audit and Accounting Guide *Health Care Organizations* (2007/08) (product no. 012617kk)
- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Audit Sampling* (2007) (product no. 012537kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2007) (product no. 012777kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- *Compilation and Review Alert—2007/08* (product no. 022308kk)
- Audit Risk Alert *Independence and Ethics—2007/08* (product no. 022478kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Checklist and Illustrative Financial Statements for State and Local Governments* (product no. 009037kk)
- *Checklist and Illustrative Financial Statements forNot-For-Profit Organizations* (product no. 008987kk)
- *Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Requirements* (product no. 006627kk)
- *Accounting Trends and Techniques—Not-For-Profit Organizations* (product no. 006616kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)

AICPA reSOURCE: Accounting and Auditing Literature

.139 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. 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.

Continuing Professional Education

.140 The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry. Among the many courses, the following may be of specific interest to auditors of organizations subject to *Government Auditing Standards* and Circular A-133 audits.

- *State & Local Government Strategic Briefing—2006/2007*
- *Foundations in Governmental Accounting*

- *Governmental Accounting and Auditing Update—2006/2007 Edition*
- *Workpaper Techniques for Government and Nonprofit Organizations*
- *Government Accounting and Reporting: Putting It All Together*
- *Audits of HUD-Assisted Projects*

.141 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.142 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for both. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to auditors of organizations subject to *Government Auditing Standards* and Circular A-133 audits are:

- *Yellow Book: An Overview*
- *2007 Annual Update-Government: GASB Activities*
- *Governmental and NPO Workpaper Preparation Techniques Overall Approach*
- *Fraud in Exempt Organizations: The Governmental and Not-for-Profit Environments*

.143 To register or learn more, visit www.cpa2biz.com.

Webcasts

.144 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high-quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

Member Service Center

.145 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.146 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. You can reach the Technical Hotline at (888) 777-7077.

Ethics Hotline

.147 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.

Industry Conference

.148 The AICPA sponsors four annual conferences that focus on GAS and Circular A-133 topics in the summer and fall of each year.

.149 *Governmental Accounting and Auditing Update Conference (GAAC) EAST* is held in late summer in Washington, D.C., and its counterpart, *Governmental Accounting and Auditing Update Conference (GAAC) WEST*, takes place in Tempe, AZ in early fall. They are designed for CPAs working in federal, state, and local government; public practitioners with government clients; and regulators who need to be aware of emerging developments should attend this conference to remain current on the issues. Attending one of these conferences is a great way to receive timely guidance along with practical advice on how to handle new legislation and standards from key government officials and representatives of the accounting profession—including the standard setters themselves.

.150 *AICPA National Governmental and Not-for-Profit Training* is held in Lake Buena Vista, FL. If you need hands on training and are a CPA in public practice—or a governmental or not-for-profit staffer—then this conference is for you. You'll hear directly from the standards setters and industry leaders on a variety of topics including developments in governmental accounting and auditing, the latest in proposed regulations and laws on the local, state, and federal government levels, as well as those affecting the not-for-profit sector and more.

.151 *Not-for-Profit Industry Conference* is held in early summer in Washington, D.C. The conference offers a wide range of topics geared to NPO professionals at every level: tax, management, audit and accounting issues, fundraising, and regulatory issues.

.152 For further information about the conferences, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA Governmental Audit Quality Center

.153 The GAQC is a firm-based, voluntary membership center designed to improve the quality of governmental audits and the value of such audits to purchasers of governmental audit services. Governmental audits are audits and attestation engagements performed under *Government Auditing Standards* of federal, state, or local governments; not-for-profit organizations; and certain for-profit organizations, such as housing projects and colleges and universities that participate in governmental programs or receive governmental financial assistance. The GAQC keeps member firms informed about the latest developments, as well as provides tools and information to help them better manage their audit practice. Firms that join demonstrate their commitment to audit quality by agreeing to adhere to certain membership requirements.

.154 The GAQC has been in existence since September 2004. Since its launch, center membership has grown to over 850 firms from 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. The membership accounts for approximately 82 percent of the total federal expenditures covered in single audits performed by CPA firms in the Federal Audit Clearinghouse database (harvester.census.gov/sac/) for the year 2004 (the latest year with complete submission data).

.155 The Center's focus is to promote the highest quality audits and to save firms time by providing a centralized place to find information they need, when they need it, to maximize quality and practice success. Center resources include the following:

- E-mail news alerts on current audit and regulatory developments that keep member firms informed about the latest developments
- Dedicated center Web site at www.aicpa.org/GAQC with Resources, Community, Events and Products, and a complete listing of GAQC members in each state

- Online Member Discussion Forums for sharing best practices and discussing issues firms are facing
- Webcasts, Web seminars, and teleconferences updating members on a variety of technical, legislative, regulatory, and practice management subjects (note that these activities are archived on the GAQC Web site)

Help Desk—With all of the quality issues being noted in governmental audits, as discussed in this alert, your firm should consider joining the center. To enroll or learn more about the GAQC, including details on the membership requirements and fees for membership, go to www.aicpa.org/GAQC or e-mail GAQC staff at GAQC@aicpa.org. To preview member benefits, go to gaqc.aicpa.org/Memberships/.

AICPA State and Local Government Expert Panel

.156 The State and Local Government Expert Panel is an AICPA volunteer group whose purpose it is to identify state and local government financial reporting and auditing issues and to work with appropriate bodies for resolutions benefiting the public interest; to conduct liaison activities with the GASB, regulators such as the GAO and the OMB, and applicable industry associations; and to advise and assist in the development of AICPA products and services related to state and local government audits. For information about the activities of the State and Local Government Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_government.htm.

AICPA Not-For-Profit Organization Expert Panel

.157 The Not-For-Profit Organization Expert Panel is an AICPA volunteer group whose purpose it is to identify financial reporting and auditing issues unique to not-for-profit organizations and to work with appropriate bodies for resolutions benefiting the public interest; to conduct liaison activities with the AICPA Accounting Standards Executive Committee (AcSEC) and Financial Accounting Standards Board (FASB); and to advise and assist in the development of AICPA products and services related to not-for-profit organizations. For information about the activities of the Not-For-Profit Organization Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_notforprofit.htm.

Industry Web Sites

.158 The Internet covers a vast amount of information that may be valuable to auditors of organizations that are subject to *Government Auditing Standards* or OMB Circular A-133 Audits, including current industry trends and developments. Some of the more relevant sites are shown in the appendix of this alert. The governmental or not-for-profit audit practice sections of some of the larger CPA firms may also contain specific auditing and accounting information that is helpful to auditors.

.159 This Audit Risk Alert replaces Government Auditing Standards *and Circular A-133 Audits—2006.*

.160 The Audit Risk Alert Government Auditing Standards *and Circular A-133 Audits* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to sreed@aicpa.org or write to:

Susan Reed, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

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Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to auditors and accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, Practice Bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+ and+Review+Services+ Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
AICPA Governmental Audit Quality Center (GAQC)	Information and updates on the latest information relating to governmental auditing, particularly for audits performed under *Government Auditing Standards* and OMB Circular A-133	www.aicpa.org/GAQC
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov

(continued)

Web Site Name	*Content*	*Web Site*
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
General Printing Office Access	Provides links to search the Code of Federal Regulations, Federal Register, and Public Laws	www.access.gpo.gov
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov

[*The next page is 8987.*]

AAM Section 8240

Independence and Ethics Alert—2007/08

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Written by Catherine Allen, CPA
Edited by Christopher Cole, CPA CFE
Accounting and Auditing Publications

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How This Alert Helps You

.01 This Audit Risk Alert (alert) informs you of recent developments in the areas of independence and ethics for accountants—areas receiving increasing attention from regulators, investors, the news media, and others. Moreover, this alert helps you understand your independence requirements under the AICPA *Code of Professional Conduct* (Code) and, if applicable, certain other rule-making and standard-setting bodies. We present a section entitled "Digest of the AICPA Independence Rules" in plain English at the end of this alert so you can understand and apply the independence rules with greater confidence.

AICPA Independence and Ethics Developments

New and Revised AICPA Independence Rules

Performance of Nonattest Services

.02 On December 1, 2006, the Professional Ethics Executive Committee (PEEC) adopted revisions to Ethics Interpretation No. 101-3, "Performance of nonattest services," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05). The revisions relate to two types of services: tax compliance and forensic accounting services.

.03 The new rule applies to the following tax-related services:

- Preparing a tax return
- Transmitting a tax return
- Transmitting a tax payment
- Signing and filing tax returns
- Authorized representation of a client in an administrative proceeding before a taxing authority

.04 Among other things, the guidance on tax compliance services:

- Describes the criteria a member should meet to avoid independence impairment when participating in electronic filing and fund transfer programs authorized or required by taxing authorities.
- Provides that to sign and file a tax return on behalf of an attest client, the member should be duly authorized under the law and either (*a*) the relevant tax authority has prescribed procedures for such filing or (*b*) client management provides the member with a signed statement that authorizes the member to file and sign the return and the individual signing the statement has the authority to sign and file the return and has reviewed the return and accompany schedules and believes it is true, correct, and complete to the best of his or her knowledge.
- Permits a member to officially represent a client in an administrative proceeding before a taxing authority if the member first obtains the client's agreement to acceptable terms of resolution with the authority prior to making any commitments on the client's behalf.

.05 Forensic Accounting Services are litigation and investigative services that involve:

- Application of special skills in accounting, auditing, finance, quantitative methods, and certain areas of law
- Collection, analysis, and evaluation of evidential matter, and interpretation and communication of findings

.06 The new rules on forensic accounting services differentiate between activities that are considered to impair independence because they give the appearance of advocacy of a client's position (for example, serving as an expert witness), versus those that would not (for example, serving as a fact witness). The interpretation of expert witness as a service that impairs independence is more restrictive than the previous rule, Ethics Ruling No. 101, "Client Advocacy and Expert Witness Services" (AICPA, *Professional Standards*, vol. 2, ET sec. 191.202–203); that ruling has been deleted to conform to the revised interpretation.

.07 The revised standard became effective February 28, 2007. The following transition periods apply to tax and forensic accounting services engagements subject to the new rules:

- **Tax Services—**Independence would not be impaired as a result of the more restrictive requirements of the tax compliance services provisions, provided such services are pursuant to engagements commenced prior to February 28, 2007 and completed prior to January 1, 2008, and the member complied with all applicable independence interpretations and rulings in effect on February 28, 2007.
- **Forensic Accounting Services—**Independence would not be impaired as a result of the more restrictive requirements of the forensic accounting services provisions, provided such services are pursuant to engagements commenced prior to February 28, 2007, and the member complied with all applicable independence interpretations and rulings in existence on February 28, 2007.

.08 On April 26, 2007, the PEEC approved editorial revisions to Interpretation 101-3, which were intended to clarify that a member's independence would be impaired if the member established or maintained internal controls (including performing monitoring activities) for a client. Thus, the PEEC struck General Requirement 2e, which stated that the client must agree to establish and maintain internal controls, and moved the requirement to the "General Activities" section of the rule, which provides examples of activities that impair independence if performed by a member. Conforming edits were also made to the footnotes appearing in the section of Interpretation 101-3 entitled, "Internal Audit Assistance Services."

.09 The revised standard is available on the AICPA Web site at www.aicpa.org/about/code/et_101.html#et_101.05.

.10 The PEEC has updated the basis for conclusions to describe both the additional guidance for tax compliance and forensic accounting services and the editorial revisions to the standard. The document, titled *Background and Basis for Conclusions: Revisions to Interpretations and Rulings Under Rule 101—Independence,* is available at www.aicpa.org/download/ethics/Basis_for_Conclusions_Non_Attest_Services.pdf.

New Independence Guidance (Independence Impact of Providing FIN 48 Services to an Attest Client)

.11 In August 2007, the staff of the Professional Ethics Division issued nonauthoritative guidance (in the form of a frequently asked question, or FAQ) on the question of whether, under Interpretation 101-3, "Performance of nonattest services," members could assist an attest client in applying Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, while maintaining independence. The staff of the Professional Ethics Division issued an FAQ that addresses whether independence is affected when a member helps an attest client apply FIN 48. The FAQ indicates that such services could be provided if the member met all of the requirements of Interpretation 101-3 and is satisfied that the client will be able to make informed judgments on the results of FIN 48 services. For example, to make an informed judgment, the client should understand why tax positions do or do not meet the "more likely than not" threshold and the basis for any unrecognized tax benefit. In this way, the client may take responsibility for the amounts reported in the financial statements as a result of FIN 48.

.12 The FAQ was incorporated as Question 23 into an existing FAQ document that is available on the Professional Ethics Division's Web site at www.aicpa.org/download/ethics/nonattest_q_a.pdf.

Compliance Reminder Regarding Other Authoritative Bodies

.13 The independence and ethics rules under the Code apply to all members of the AICPA. However, other rule-making and standard-setting bodies, such as the U.S. Securities and Exchange Commission (SEC or Commission), the Public Company Accounting Oversight Board (PCAOB), the Government Accountability Office (GAO), the U.S. Department of Labor (DOL), state boards of accountancy, and state CPA societies, also have independence and ethics rules with which members must comply, if applicable, in addition to the AICPA rules. The rules of the SEC, PCAOB, and GAO are discussed briefly in this alert. You should refer to the original text of each organization's rules for full guidance.

SEC Independence Rules

.14 Rule 2-01, *Qualifications of Accountants*, of Regulation S-X sets forth the SEC's independence rules. The rule is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance. Accordingly, the rule establishes restrictions on financial, employment, and business relationships between an accountant and an audit client and the provision of certain nonaudit services to an audit client.

.15 Rule 2-01(b) begins with a general standard of auditor independence, which states:

> "The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission."

.16 The succeeding paragraphs reflect the application of the general standard to particular circumstances. In addition, Rule 2-01(b) states:

> "The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in paragraph 2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: (*a*) creates a mutual or conflicting interest between the accountant and the audit client; (*b*) places the accountant in the position of auditing his or her own work; (*c*) results in the accountant acting as management or an employee of the audit client; or (*d*) places the accountant in a position of being an advocate for the audit client."

.17 The rule indicates that the above factors are general guidance only and their application may depend on particular facts and circumstances. Thus, Rule 2-01 also provides that:

> ". . . in determining whether an accountant is independent, the Commission will consider all relevant facts and circumstances. For the same reason, registrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services, that are not explicitly described in the Rule."

.18 The staff of the SEC Office of the Chief Accountant periodically updates a document entitled *Application of the Commission's Rules on Auditor Independence: Frequently Asked Questions* (available at www.sec.gov/info/accountants/ocafaqaudind080607.htm). The staff updated the document in August 2007 to address the following questions:

- Do second mortgages, home improvement loans, equity lines of credit, and similar obligations collateralized by a primary residence qualify for "grandfather" status?
- Is independence impaired if a successor auditor performed certain prohibited nonaudit services (for example, bookkeeping) during the period of the financial statements audited by a predecessor auditor?
- Is independence impaired if an auditor translates its client's documents that are filed with the Commission?
- Is independence impaired if the auditor of an employee benefit plan that files Form 11-K provides prohibited nonaudit services to the nonaudit client sponsor of the plan?
- Must auditors of a parent company's financial statements be independent of entities consolidated solely due to the application of FIN 46(R), *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*?
- Should the audit committee of the sponsor of an employee benefit plan preapprove audit services provided to the plan?

- Should audit committees preapprove services provided by an issuer's principal accountant to variable interest entities that are consolidated under FIN 46(R)?
- Should an issuer's proxy disclosures include amounts paid to the principal auditor for the audit of the issuer's employee benefit plan?
- Do "cooling off" rules apply to all audited periods included in an initial public offering filed with the SEC?

PCAOB Rules Regarding Independence and Ethics

.19 The PCAOB has the authority to establish ethics and independence standards in accordance with sections 103(a), "Auditing, Quality Control, and Ethics Standards," and 103(b), "Independence Standards and Rules," of the Sarbanes-Oxley Act (SOX). Firms that issue audit reports on public companies are required to register with the PCAOB. Failure to do so may result in disciplinary action. Additionally, any registered public accounting firm or person associated with such a firm that fails to adhere to applicable PCAOB standards may be the subject of a PCAOB disciplinary proceeding in accordance with Section 105 of SOX. Under Section 107 of SOX, PCAOB rules become effective only after they are approved by the SEC. The PCAOB rules pertaining to independence and ethics also include PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*; PCAOB Rule 3500T, *Interim Ethics Standards*; and PCAOB Rule 3600T, *Interim Independence Standards* (AICPA, *PCAOB Standards and Related Rules*). These rules are summarized in this alert, as is the new independence rule approved by the PCAOB in 2007. The full text of these rules can be found at www.pcaobus.org/Rules/Rules_of_the_Board/Section_3.pdf.

New PCAOB Independence Rule

.20 In May 2007, the PCAOB adopted Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*, which addresses the manner in which auditors must obtain preapproval of internal control-related services from audit committees. This would include, for example, advisory services to help a client improve internal controls in a particular financial reporting area, perhaps in connection with the design of a new information system. Specifically, the rules require a registered public accounting firm seeking preapproval to (1) describe proposed internal control-related engagements, in writing, for the audit committee; (2) discuss with the audit committee the potential effects of the services on the firm's independence; and (3) document the substance of that discussion. The new rule is intended to enhance the quality of information provided to the audit committee and discussion between the auditor and committee of the potential effect of internal control-related services on independence. The SEC approved the rule in July 2007; it becomes effective for audits of fiscal years ending on or after November 15, 2007. Earlier adoption is permitted.

Compliance With Auditing and Related Professional Practice Standards

.21 PCAOB Rule 3100 generally requires all registered public accounting firms to adhere to the PCAOB's auditing and related professional practice standards, which encompass auditing, attestation, quality control, ethics, and independence standards, in connection with the preparation or issuance of any audit report for an issuer and in its auditing and related attestation practices. This rule also requires registered public accounting firms and their associated persons to comply with all *applicable* standards. Accordingly, if the PCAOB's standards do not apply to an engagement or other activity of the firm, PCAOB Rule 3100, by its own terms, does not apply to that engagement or activity.

Interim Ethics Standards

.22 PCAOB Rule 3500T designates the provisions of the Code on integrity and objectivity as "Interim Ethics Standards." Accordingly, in connection with the preparation or issuance of any audit report, a registered public accounting firm and its associated persons should comply with ethics standards as described in Rule 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 102.01), and interpretations and rulings thereunder, as in existence as of April 16, 2003, to the extent not superseded or amended by the PCAOB.

Interim Independence Standards

.23 PCAOB Rule 3600T designates the provisions of the Code regarding independence and existing standards and interpretations of the Independence Standards Board (ISB) as "Interim Independence Standards." This rule states that, in connection with the preparation or issuance of any audit report, a registered public accounting firm and its associated persons shall comply with the following independence standards, to the extent not superseded or amended by the PCAOB:

- Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.01), and interpretations and rulings thereunder, as in existence on April 16, 2003
- ISB Standards No. 1, *Independence Discussions with Audit Committees*; No. 2, *Certain Independence Implications of Audits of Mutual Funds and Related Entities*; and No. 3, *Employment with Audit Clients*
- ISB Interpretations No. 99-1, *Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)*; No. 00-1, *The Applicability of ISB Standard No. 1: When "Secondary Auditors" Are Involved in the Audit of a Registrant*; and No. 00-2, *The Applicability of ISB Standard No. 1: When "Secondary Auditors" Are Involved in the Audit of a Registrant—An Amendment of Interpretation 00-1*

.24 To the extent that the SEC's rules are more or less restrictive than the PCAOB's Interim Independence Standards, registered public accounting firms must comply with the more restrictive requirements.

GAO Independence Standard

.25 CPAs, non-CPAs, government financial auditors, and performance auditors who audit federal, state, and local governments as well as not-for-profit and for-profit recipients of federal (and some state) grant and loan assistance should be familiar with the ethics and independence requirements of the *Government Auditing Standards* (GAS, also referred to as the Yellow Book). The GAO independence rules are in some cases very similar to the AICPA independence rules; however, in other cases, the GAO independence rules are more restrictive.

.26 In July 2007, the Comptroller General of the United States issued the 2007 revision of the Yellow Book, which supersedes the 2003 edition. (It also updates the version released in January 2007.) Changes reflected in Chapters 2 and 3 of the Yellow Book, which address professional ethics and independence, include:

- Increased emphasis on ethical principles as the foundation, discipline, and structure behind the implementation of the government auditing standards.
- Five ethical principles that should guide auditors' work, which are presented in Chapter 2 (previously, references to ethics were scattered throughout the document).
- Reorganization of nonaudit services independence rules into three categories for easier reference.
- New guidance on the auditor's responsibilities if the auditor discovers an impairment of independence after the audit report has been issued.

.27 Note: Though not an ethics requirement, the 2007 version of the Yellow Book incorporates a new requirement that an accounting firm include policies and procedures in its system of quality control that address, among other things, independence and ethical requirements.

.28 The five ethical principles found in Chapter 2, which is devoted exclusively to ethical conduct, are:

1. The public interest
2. Integrity
3. Objectivity
4. Proper use of government information, resources, and position
5. Professional behavior

.29 The independence rules, in substance, are unchanged. For nonaudit services, they continue to require the auditor to observe two overarching principles to enable performance of such services. The revised Yellow Book has summarized the guidance into three distinct categories of nonaudit services. The categories and examples of each follow:

1. ***Nonaudit services that do not impair auditor independence and, therefore, do not require compliance with the supplemental safeguards.*** For example, routine activities performed in connection with the financial statement audit, such as providing technical advice and periodic training.
2. ***Nonaudit services that would not impair independence if supplemental safeguards are implemented.*** The Yellow Book requires accounting firms to apply seven supplemental safeguards, some of which include the use of separate personnel on audit and nonaudit engagement teams and documentation of the firm's understanding with the client regarding the scope of the engagement and respective responsibilities of the client and the firm. Examples include: helping the client evaluate potential employment candidates and preparing routine tax filings.
3. ***Nonaudit services that impair independence.*** These are services that, due to their nature, are inconsistent with one or both of the overarching principles. Therefore, adherence to the safeguards does not mitigate the independence concerns. Examples include: maintaining or preparing an audit client's basic accounting records, posting client-coded entries to the general ledger, and providing payroll services to the client when the results of those services are material to the financial statements.

.30 The revised Yellow Book is available at www.gao.gov/govaud/ybk01.htm. For further guidance on applying the GAO independence rules, refer to guidance the GAO issued in 2002 entitled, *Answers to Independence Standard Questions*, which can be found at www.gao.gov/govaud/d02870g.pdf. An updated version of this guidance, which will change only the paragraph references to those of the revised Yellow Book, is expected. Additional information about the GAO independence standard is available at www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/Resources+and+Tools/GAO+Independence+Rules.htm.

On the Horizon

Proposed AICPA Ethics Interpretations and Rulings

.31 On August 13, 2007, the PEEC issued proposed Interpretation 101-17, a proposal addressing the concept of a "network firm." Under the proposal, an association of accounting firms is a network (and the firms within the network are "network firms") if the firms in the association share one or more specified characteristics, such as profit-sharing, common control, or the use of a common brand name in the firm name. Under a proposed, related interpretation, network firms would be required to maintain independence of certain attest clients of all firms in the network. The proposal is the PEEC's latest effort to harmonize its ethics rules with those of the International Federation of Accountants (IFAC), which adopted a similar definition in 2006. Comments are due November 15, 2007. The exposure draft may be obtained at www.aicpa.org/download/ethics/August_13_2007_Exposure_Draft.pdf.

.32 On May 15, 2007, the PEEC proposed Interpretation 102-7 under Rule 102: Other Considerations: Meeting the Objectives of the Fundamental Principles. In connection with that proposal, the PEEC also issued *Proposed Framework for Meeting the Objectives of the Fundamental Principles*. The proposed framework provides guidance to all AICPA members who encounter ethical matters that are not explicitly addressed by the Code. The framework is consistent with the IFAC Code of Ethics for Professional Accountants (the IFAC Code) and it brings the AICPA Code closer to convergence with international ethics standards. Similar to the "Conceptual Framework for AICPA Independence Standards," (AICPA, *Professional Standards*, vol. 2, ET sec. 100.01) this framework would require members to consider specific threats to meeting the Code's fundamental principles, such as integrity and due care. Where threats are identified, appropriate safeguards may be applied to eliminate or reduce those threats. Comments on the proposal were due August 15, 2007. The PEEC is expected to discuss the comments and consider whether to issue a final interpretation or framework or both at its November 2007 open meeting.

Other AICPA Projects

International Ethics Convergence and Monitoring

.33 The AICPA is a member body of IFAC, the global organization for the accounting profession. IFAC consists of approximately 163 member bodies, including most of the major accounting associations around the world. The International Ethics Standards Board for Accountants (IESBA), which includes AICPA representation, develops ethical standards and guidance for professional accountants for use around the world, which is published in the IFAC Code. The PEEC has formed a task force to monitor the activities of the IESBA and consider how the AICPA and IFAC codes differ. Where appropriate, the task force will recommend changes to the AICPA Code to harmonize it with the IFAC guidance. Any proposed changes are exposed to membership for comment prior to adoption by the PEEC. For example, the IFAC Code is drafted primarily in a threats and safeguards framework approach. The "Conceptual Framework for AICPA Independence Standards" is consistent with the framework used in the IFAC Code. As indicated above, this past year, the PEEC proposed expanding the conceptual framework approach to all of the fundamental principles underlying the AICPA Code and a definition and interpretation of "network firm."

.34 The IFAC Code may affect U.S. CPAs in a number of ways. For example:

- A firm whose attest client is acquired by a foreign entity could become subject to standards that are based on the IFAC Code.
- A firm belonging to an international network and meeting the IFAC definition of "network firm" would be subject to the independence rules regarding all audit clients being served by the network.
- A firm that acquires a new attest client from another (typically larger) firm may need to conform to the IFAC Code due to the client's international activities (at the parent or subsidiary level) or the expectations of the client's non-U.S. vendors, customers, lenders, or affiliates.

.35 Currently, the IESBA has two exposure drafts pending:

- *Proposed Revised Section 290 of the Code of Ethics for Professional Accountants, Independence—Audit and Review Engagements, and Proposed Section 291, Independence—Other Assurance Engagements*, issued December 2006, proposed several significant changes to the independence rules (sections 290 and 291 of the IFAC Code) addressing, among other things, partner rotation, public interest entities, and partner compensation. The IESBA considered revisions to these sections at its October 24–26, 2007 meeting.
- *Proposed Revised Section 290 of the Code of Ethics for Professional Accountants, Independence—Audit and Review Engagements, and Proposed Section 291, Independence—Other Assurance Engagements, issued July 2007,* proposed three additional amendments to sections 290 and 291 of the IFAC Code by expanding

the guidance on internal audit services, the impact of significant fees to an accounting firm, and contingent fees. Comments on the second proposal were due October 15, 2007.

Changes to Independence Rules on Auditor Indemnification Pending Further Research

.36 Changes to independence rules regarding auditor indemnification and related issues are still pending. Two separate proposals have been exposed to date and the feedback has been diverse. The PEEC has initiated research to better understand the various rules and laws on the use of auditor indemnification and similar provisions in the United States and abroad. The PEEC is also monitoring auditor liability reform initiatives that are currently pending throughout the world.

Potential Guidance on Contingent Fees

.37 The PEEC appointed the Contingent Fee Task Force to consider the appropriateness of Rule 302, *Contingent Fees* (AICPA, *Professional Standards*, vol. 2, ET sec. 302.01), and the related Interpretation No. 302-1, "Contingent fees in tax matters," (AICPA, *Professional Standards*, vol. 2, ET sec. 302.02). Among other things, the Contingent Fee Task Force is considering the clarity of the existing guidance that permits a member to accept a fee in tax matters if the member can "demonstrate a reasonable expectation, at the time of the fee arrangement, of substantive consideration by an agency with respect to the member's client."

Three-Year Project Agenda

.38 The AICPA Professional Ethics Division maintains a three-year project agenda on its Web site that lists all current and future PEEC projects. The agenda can be found at www.aicpa.org/download/ethics/PEEC_TF.pdf.

Proposed PCAOB Independence Rules

.39 On July 24, 2007, the PCAOB proposed a revision to Rule 3523, *Tax Services for Persons in Financial Reporting Oversight Roles* (AICPA, *PCAOB Standards and Related Rules*). That rule states that independence is impaired if auditors (or their affiliates) provide tax services to company managers in financial reporting oversight roles during the audit and professional engagement period. The term *audit and professional engagement period* has two components. The professional engagement period starts when an auditor is initially engaged to perform audit, review, or other attestation services (or begins performing any of these attest services, if earlier) and lasts until the auditor or client terminates the relationship by notifying the SEC. The audit period is the period covered by the financial statements or other information under audit. Under the proposed revision, the rule would no longer apply to the portion of the audit period that precedes the professional engagement period. Thus, an auditor could cease performing tax services for persons associated with a prospective audit client (that would normally be proscribed under PCAOB Rule 3523) prior to the beginning of the professional engagement period and still be considered independent. Certain allowances for tax services provided to persons associated with an existing audit client filing an initial public offering would also be provided. The proposed change would help ease difficulties companies have experienced when attempting to change audit firms. The proposal also extended the implementation period for this aspect of the rule. On or before April 30, 2008, the PCAOB will not apply Rule 3523 to tax services provided by an auditor during the audit period if the services are completed before the professional engagement period begins.

.40 The PCAOB is also proposing a new independence rule. PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*, addresses communications between auditors and audit committees and would supersede the PCAOB's existing interim standard (ISB Standard No. 1, *Independence Discussions with Audit Committees*) and two related interpretations. Compliance with the new rule, which is intended to build upon the interim standard, would be required prior to accepting a new audit engagement and at least annually thereafter. It would require the auditor to describe in writing to the audit committee all relationships between the auditor (and its affiliates) and the client (or potential client) that could reasonably be thought to bear on independence. The auditor would be required to discuss these matters with the audit committee and document the substance of that discussion.

.41 Comment periods for both PCAOB proposed rules ended September 7, 2007. More information about these proposals can be found at www.pcaob.org/Rules/Docket_017/2007-07-23_Release_2007-008.pdf.

Status of DOL Request for Comments on Independence Rules Pertaining to Employee Benefit Plan Audits

.42 On September 11, 2006, the DOL issued a request for information (RFI) seeking public comment on the advisability of the DOL amending the auditor independence rules for employee benefit plan audits subject to the Employee Retirement Income Security Act of 1974 (ERISA). This is the first time the DOL has considered its independence requirements since DOL Interpretive Bulletin 75-9 (29 CFR 2509.75-9) was issued in 1975. The DOL RFI notes that the current DOL requirements conflict with AICPA and SEC independence requirements and have caused confusion among practitioners. The comment period closed on December 11, 2006. To date, the DOL has not issued a response to the feedback it received regarding its RFI.

.43 The DOL's RFI can be found at http://ebpaqc.aicpa.org/Resources/Independence/. The comment letters received by the DOL can be found at www.dol.gov/ebsa/regs/cmt-IndPlanAccountants.html.

Digest of the AICPA Independence Rules

.44 A plain-English description of the AICPA independence rules follows. The purpose of this section is to help you to understand independence requirements under the Code and, if applicable, other rule-making and standard-setting bodies. Independence generally implies one's ability to act with integrity and exercise objectivity and professional skepticism. The AICPA and other rule-making bodies have developed rules that establish and interpret independence requirements for the accounting profession. We use the term *rules* broadly to also mean standards, interpretations, rulings, laws, regulations, opinions, policies, or positions. This guide discusses in plain English the independence requirements of the principal rule-making bodies in the United States so you can understand and apply them with greater confidence and ease.

.45 This section of the alert is intentionally concise, so it does not cover all the rules, some of which are complex, nor does it cover every aspect of the rules herein. Nonetheless, this guide should help you identify independence issues that may require further consideration. Therefore, you should always refer to the rules directly, in addition to your firm's policies on independence, for complete information.

Conventions and Key Terms Used

.46 Here are some of the conventions used in this section of the alert:

- The word ***Note*** in boldface italics emphasizes important points, highlights applicable government regulations, or indicates that a rule change may soon occur.

> We describe the rules of the SEC and PCAOB—that is, those that apply to audits of public companies—in boxed text (like this one) and provide citations to specific rules. Generally, we provide these descriptions where the SEC or PCAOB has a rule that differs from in some manner or is presented somewhat differently than the corresponding AICPA rule.

.47 This section uses the following key terms:

- *Client* (or *attest client*). An entity with respect to which independence is required.
- *Firm*. A form of organization permitted by law or regulation (whose characteristics conform to the resolutions of AICPA Council) that is engaged in the practice of public accounting.

What Is Independence?

.48 Independence is defined in the "Conceptual Framework for AICPA Independence Standards," referred to herein as the Conceptual Framework, as:

a. *Independence of mind*. The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

b. *Independence in appearance*. The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.

.49 These definitions reflect the longstanding professional requirement that members who provide services to entities for which independence is required be independent both in fact (that is, "of mind") and in appearance.

When Is Independence Required, and Who Sets the Rules?

.50 AICPA professional standards require your firm, including the firm's partners and professional employees, to be independent in accordance with Rule 101, *Independence*, of the Code whenever your firm performs an attest service for a client. Attest services include:

- Financial statement audits
- Financial statement reviews
- Other attest services as defined in the Statements on Standards for Attestation Engagements (SSAEs)

.51 Performing a compilation of a client's financial statements does not require independence. However, if a nonindependent firm issues such a compilation report, the report must state, "I am (we are) not independent with respect to XYZ Company."[1]

.52 You and your firm are not required to be independent to perform services that are not attest services (for example, tax preparation or advice, or consulting services, such as personal financial planning) if they are the only services your firm provides to a particular client.

> ***Note:*** You should familiarize yourself with your firm's independence policies, quality control systems, and list or database of attest clients.

In Addition to the AICPA, Who Else Sets Independence Rules?

.53 Many clients are subject to oversight and regulation by governmental agencies. For example, the GAO sets independence rules that apply to entities audited under *Governmental Auditing Standards*. For these clients (and others, such as those subject to regulation by the SEC or DOL), you and your firm must also comply with the independence rules established by those agencies.

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[1] See AICPA *Professional Standards*, vol. 2, AR sec. 100.19.

.54 The SEC regulates public companies[2] and establishes the qualifications of independent auditors. This section refers to these independence rules as *SEC rules*.

.55 The PCAOB, a private standards-setting body whose activities are overseen by the SEC, is authorized to set auditing, attestation, quality control, ethics, and independence standards for accounting firms that audit public companies. The PCAOB adopted interim ethics standards based on the provisions of the Code, Rule 102, *Integrity and Objectivity*, and Rule 101, *Independence*, and interpretations and rulings under those rules, as of April 16, 2003. It also adopted ISB Standards. To the extent that the SEC's rules are more or less restrictive than the PCAOB's interim independence standards, registered public accounting firms must comply with the more restrictive requirements.

> In addition to its detailed rules, the SEC looks to its general standard of independence and four basic principles to determine whether independence is impaired. The general standard is an appearance standard that considers whether a reasonable investor with knowledge of all relevant facts and circumstances would conclude that an accountant is independent.
>
> Under the four basic principles, an auditor cannot:
>
> 1. Function in the role of management
> 2. Audit his or her own work
> 3. Serve in an advocacy role for the client
> 4. Have a mutual or conflicting role with the client

> ***Note:*** The SEC has recently voted to approve PCAOB Rule 3525, *Audit Committee Preapproval of Non-audit Services Related to Internal Control Over Financial Reporting*, which addresses the manner in which auditors must obtain preapproval of internal control-related services from audit committees.

.56 Other organizations that have established independence requirements that may be applicable to you and your firm include:

- State boards of accountancy
- State CPA societies
- Federal and state agencies

.57 You should contact these organizations directly for further information.

> ***Note:*** 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.

.58 Once you determine that your firm provides attest services to a client and which rules apply, the next step is to determine how the rules apply to you.

Applying the Rules—Covered Members and Other Firm Professionals

How Do the Independence Rules Apply to Me?

.59 Whenever you are a *covered member*, you become subject to the full range of independence rules with regards to a specific client. You are a covered member if you are:

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[2] This includes companies that are registered with or are otherwise regulated by the U.S. Securities and Exchange Commission (SEC) or companies that file audited financial statements with the SEC, including foreign filers.

1. An individual on the client's attest engagement team;
2. An individual in a position to influence the client's attest engagement;
3. A partner or manager who provides more than 10 hours of nonattest services to that attest client;
4. A partner in the office in which the lead attest engagement partner primarily practices in connection with the client's 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[3] by any of the individuals or entities described in items 1–5 or by two or more such individuals or entities if they act together.

The SEC uses the term *covered person*[4] to describe the individuals in a firm who are subject to SEC independence rules. This term is largely consistent with the AICPA's term *covered member*. The only difference between the two definitions is that of classification. The AICPA considers consultants to be in a position to influence the engagement (SEC uses the term *chain of command*), whereas the SEC considers these persons to be on the attest engagement team. Overall, the definitions are the same.

Note: This alert uses the term *covered member* (and *covered person* with respect to SEC rules) extensively in explaining the *personal* independence rules (for example, rules that apply to you and your family's loans, investments, and employment). Therefore, it is important that you understand these terms before proceeding. Also, remember to check with your firm to determine whether its independence policies are more restrictive than the AICPA or SEC rules.

Do Any of the Rules Apply to Me If I Am Not a Covered Member?

.60 Yes; there are two categories of relationships with a client that, due to their magnitude, impair independence even if you are not a covered member. These relationships are:

- Director, officer, or employee (or in any capacity equivalent to a member of management), promoter, underwriter, voting trustee of the client, or trustee of any of the client's employee benefit plans
- Ownership of more than five percent of an attest client's outstanding equity securities (or other ownership interests)

.61 The independence rules prohibit these relationships if you are a partner or professional employee in a public accounting firm.

What If I Was Formerly Employed by a Client or I Was a Member of the Client's Board of Directors?

.62 There are a number of things you must be aware of, as follows:

1. You may not participate in the client's attest engagement, or be in a position to influence the engagement, for any periods covering the time that you were associated with the client. So, for example, if you worked for the client in 2007, you would be prohibited from serving on the client's

[3] As defined by generally accepted accounting principles (GAAP) for consolidation purposes.

[4] See Rule 2-01(f)(11). Also see *Discussion of Rule 2-01, Covered persons in the firm*, in the SEC's Final Rule Release [Section IV (H)(9)].

audit engagement for the 2007 fiscal year financial statements. You also could not serve in a position that would allow you to influence the 2007 fiscal engagement. For example, you could not directly or indirectly supervise the audit engagement partner.

2. Before becoming a covered member, you must:
   - — Terminate any relationships with the client as described in Interpretation No. 101-1C, "Interpretation of Rule 101," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02).[5]
   - — Dispose of all financial interests[6] in the client.
   - — Collect and repay all loans to or from the client (except those specifically permitted or grandfathered).[7]
   - — Cease active participation in the client's employee benefit plans (except for benefits under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA)).
   - — Liquidate or transfer any vested benefits in the client's retirement plans.

What Rules Apply If I Am Considering Employment With an Attest Client?

.63 If an attest client offers you employment, or you seek employment with an attest client, you may need to take certain actions. If you are on that client's attest engagement team or can otherwise influence the engagement, you must promptly report any employment negotiations with the client to the appropriate person in your firm. You cannot participate in the engagement until your negotiations with the client end.

What If I Accept Employment or a Board Position With an Attest Client?

.64 Being employed by a client or a member of the client's board of directors impairs independence. However, even if you leave your firm to take a position with a client, independence may still be affected. This would be the case if you accept a "key position" with the client, which means that you prepare financial statements or accounting records or are otherwise able to influence the client's statements or records. A few examples of "key positions" are controller, chief financial officer, or treasurer. Remember the substance, and not only the position title, determines whether a position is "key" or not.

.65 If you meet the following conditions, having a key position with a client will not impair your firm's independence:

- The amounts the firm owes you (capital balance or retirement benefits) are based on a fixed formula and are not material to the firm.
- You cannot influence the firm's operations or financial policies.
- You do not participate or appear to participate in the firm's business or professional activities.

.66 Your firm must consider whether it should apply additional procedures to ensure that your transition to the client has not compromised the firm's independence and that independence will be maintained going forward. Some things the firm should consider are:

- Whether you served on the engagement team and for how long
- Positions you held with the firm and your status

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[5] This includes the director, officer, or employee, or in any capacity equivalent to that of a member of management, promoter, underwriter, or voting trustee, or trustee for the entity's pension and profit-sharing trust.

[6] See the "When Do My Financial Interests—or My Family's—Impair Independence?" section.

[7] Also see AICPA Ethics Interpretation No. 101-5, "Loans from financial institution clients and related terminology," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.07).

- Your position and status with the client
- The amount of time that has passed since you left the firm

.67 Based on these factors, the firm may decide to:

- Adjust the audit plan to reduce the risk that your knowledge of the plan could lessen the audit's effectiveness
- Reconsider the successor engagement team to ensure it has sufficient stature and experience to deal effectively with you in your new position, if you will interact significantly with the engagement team
- Perform an internal technical review of the next attest engagement to determine whether engagement personnel exercised the appropriate level of professional skepticism in evaluating your work and representations[8]

> Under SEC rules, if a former partner will be in an "accounting role" or "financial reporting oversight role" with an SEC audit client, he or she may not have:
>
> - A capital balance with the firm
> - A financial arrangement with the firm (for example, retirement benefits) that is not fully funded by the firm
> - Influence over the firm's operations or financial policies
>
> The SEC uses the terms *accounting role* and *financial reporting oversight role* in its rules; taken together, these terms are consistent with the AICPA term *key position*. The SEC also requires a one-year "cooling-off period" for members of the audit engagement team who assume a *financial reporting oversight role* with that client. In other words, if an engagement team member who participated on the audit of the current (or immediately preceding) fiscal year goes to work for a client, the firm's independence would be impaired.
>
> Only members who have provided fewer than 10 hours of audit, review, or other attest services to the client (and did not serve as either the lead or concurring partner for the client) are *not* considered to be members of the audit engagement team for purposes of this rule.
>
> This rule applies to the audit client and its consolidated entities.

Applying the Rules—Family Members

When Is My Family Subject to the Rules?

.68 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. For example, your spouse's investments must be investments that you could own under the rules. This rule applies even if your spouse keeps the investments in his or her own name or with a different broker.

.69 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.
2. Immediate family members of *certain* covered members may invest 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 invest in this way are:

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[8] An objective professional with the appropriate stature and expertise should perform this review and the firm should take any recommendation(s) that result from the review.

— Partners and managers who provide only nonattest services to the client

— 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

.70 In other words, immediate family of individuals on the attest engagement team *or* of those who can influence the attest engagement team *may not* invest in a client under any circumstances.

> Under SEC rules, the immediate family of certain covered persons may have financial interests in SEC audit clients only if such interests are an *unavoidable consequence* of their participation in an employee compensation or benefit plan. This means that if nonclient investments are available through the plan, the immediate family member must choose those investments.

What About My Other Close Relatives?

.71 The close relatives (siblings, parents, and nondependent children) of covered members are subject to some employment and financial restrictions. Your close relative's employment by a client *in a key position* impairs independence. (An exception to this rule is provided to persons who are covered members *solely* because they provide nonattest services to a client.)

.72 Rules pertaining to your close relatives' financial interests depend 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 would 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.

> Under SEC rules, your close family members include your spouse (or equivalent), dependents, parents, nondependent children, and siblings. If you are a covered person, your independence is affected if your close family member:
>
> - Has an *accounting role* or *financial reporting oversight role* with the client. For example, the family member is a treasurer, chief financial officer, accounting supervisor, or controller.
> - Owns more than five percent of a client's equity securities or controls the client.
>
> In addition, independence is considered to be impaired if any partner's close family member controls a client.

Financial Relationships

When Do My Financial Interests—or My Family's—Impair Independence?

.73 This section discusses various types of financial relationships and how they affect independence. Although this section focuses on how these rules apply to you and your family, keep in mind that your firm is also subject to the financial relationship rules (since firms are included in the definition of *covered member*).

.74 As a covered member, you (and your spouse and dependents) are not permitted to have a:

- Direct financial interest in that client, regardless of how immaterial it would be to your net worth.
- Material indirect financial interest in that client.

  Note: The Code does not define or otherwise provide guidance on determining materiality. In determining materiality, you should apply professional judgment to all relevant facts and circumstances and refer to applicable guidance in the professional literature. Both qualitative and quantitative factors should be considered.

.75 In addition, if you commit to acquire a direct financial interest in a client, your independence would be impaired. For example, if you sign a stock subscription agreement with the client, your independence would be considered impaired as soon as you sign the agreement.

.76 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.

.77 Direct financial interests are financial interests that are:

1. Owned by you directly; or
2. Under your control; or
3. Beneficially owned[9] by you through an investment vehicle, estate, trust, or other intermediary if you can either:
   a. Control the intermediary; or
   b. Have the authority to supervise or participate in the intermediary's investment decisions.

.78 For example, if you invest in a participant directed 401(k) plan, whereby you are able to select the investments held in your account or are able to select from investment alternatives offered by the plan, you would be considered to have a direct financial interest in the investments held in your account.

.79 You also have a direct financial interest in a client if you have a financial interest in a client through one of the following:

- A partnership, if you are a general partner
- A Section 529 savings plan, if you are the account owner
- An estate, if you serve as an executor and meet certain other criteria
- A trust, if you serve as the trustee and meet certain other criteria

.80 For example, suppose you are a covered member with respect to ABC Co. and you are also a general partner of XYZ Partnership. XYZ Partnership owns shares in ABC Co. Under the independence rules, you would be deemed to have a direct financial interest in ABC, which would impair your independence, regardless of materiality.

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[9] A financial interest is beneficially owned if an individual or entity is not the record owner of the interest, but has a right to some or all of the underlying benefits of ownership. These benefits include the authority to direct the voting or the disposition of the interest or to receive the economic benefits of the ownership of the interest.

.81 An indirect financial interest arises if you have a financial interest that is beneficially owned through an investment vehicle, estate, trust, or other intermediary, when you can neither control the intermediary nor have the authority to supervise or participate in the intermediary's investment decisions.

.82 For example, if you invest in a defined contribution plan that is not participant-directed and you have no authority to supervise or participate in the plan's investment decisions, you would be considered to have an indirect financial interest in the underlying plan investments.

> ***Note:*** Interpretation No. 101-15, "Financial Relationships," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.17), of the Code provides extensive examples of various types of financial interests and whether they should be considered to be direct or indirect financial interests, including investments in mutual funds, retirement and savings plans, Section 529 plans, trusts, partnerships, and insurance products.

> The SEC classifies your investment in a client held through another entity (the intermediary) as *direct* if either of the following is true:
>
> - You participate in the intermediary's investment decisions or have control over them.
> - The investment in the client by the intermediary, which is not a diversified mutual fund, represents 20 percent or more of the value of its total investments.
>
> If neither of the above applies, your investment in a client through another entity would normally be considered to be an indirect financial interest in that client.

What If My Immediate Family or I Receive a Financial Interest as a Result of an Inheritance or a Gift?

.83 If, due to an unexpected event, you or members of your immediate family receive a financial interest in an attest client that would impair your independence, you may qualify under an exemption in the rules if you meet the following criteria:

- The financial interest was unsolicited.
- You dispose of the interest as soon as practicable—but no later than 30 days after you become aware of it and have the right to dispose.
- If you do not have the right to dispose of the interest (for example, as in the case of stock options or restricted stock), you do not participate in the attest engagement for the client.

What Are the Rules That Apply to My Mutual Fund Investments—and Those of My Family—If My Firm Audits Those Mutual Funds?

.84 If you are a covered member with respect to a mutual fund attest client of your firm, and you or your immediate family own shares in the fund, you have a direct financial interest in the fund client.

> The SEC rules also prohibit the firm and covered persons and their immediate family members from having any financial interest in an entity (even one that is not a client) that is part of an *investment company complex* that includes an audit client.

Which Rules Pertain to My Mutual Fund Investments—and Those of My Family—If My Firm Audits Companies Held in Those Mutual Funds?

.85 Financial interests that you and your immediate family have in clients through a mutual fund are considered to be indirect financial interests in those clients unless the fund is a diversified mutual fund.

.86 If a mutual fund is diversified, and you or your immediate family own five or fewer percent of its outstanding shares, the fund's holdings in clients for which you are a covered person will *not* be considered material indirect financial interests in those clients. Thus, you would be relieved of the burden of having to monitor whether, and to what degree, the fund invests in audit clients for which you are a covered person.

.87 If the fund is *not* diversified, or you or your family own more than five percent of the fund's equity, you should treat the fund's holdings as indirect financial interests. Here is an illustration.

.88 Suppose ABC Mutual Fund, a nondiversified mutual fund, owns shares in a client, XYZ:

- ABC's net assets are $10,000,000.
- Your shares in ABC Mutual Fund are worth $50,000.
- ABC has 10 percent of its assets invested in XYZ.
- Your indirect financial interest in XYZ is $5,000 ($50,000 x .10).

If $5,000 is material to your net worth, independence would be considered to be impaired.

May I Have a Joint Closely Held Investment With a Client?

.89 As a covered member, if you or the client, individually or collectively, control an investment, that investment is considered to be a joint closely held investment. If this joint closely held investment is material to your net worth, independence would be considered to be impaired. In this rule, *client* includes certain persons associated with the client, such as officers, directors, or owners who are able to exercise significant influence over the client.

> The SEC rules prohibit you and your immediate family from having a joint-business venture with a client or with persons associated with the client in a decision-making capacity—meaning officers, directors, or substantial shareholders, whether or not the venture is material to your net worth. The SEC believes that these joint ventures, whether material or not, cause the client and the audit firm to have mutuality of interests, which impairs independence.

May My Family or I Borrow Money From or Lend Money to a Client?

.90 If you are a covered member with respect to an attest client, you and your immediate family may not have a loan to or from the client or:

- An officer or director of the client
- An individual holding 10 percent or more of the client's outstanding equity securities (or other ownership interests)

Investments in a client's bonds are considered a direct financial interest in that client.

.91 There are certain exceptions to this rule. First, there are specific loans that covered members are permitted to have from financial institution attest clients. They are:

- Car loans and leases collateralized by the vehicle
- Credit card and overdraft reserve account balances not exceeding $10,000 (that is, by payment due date, including any grace period)

- Passbook loans fully collateralized by cash deposits at the same financial institution
- Loans fully collateralized by an insurance policy

.92 In addition, if you have a loan from a client financial institution (a bank, for example) that meets certain criteria, your loan *may* be "grandfathered" (that is, you may be allowed to keep it). For your loan to be grandfathered, you must have obtained it under normal lending procedures, terms, and requirements. The following loans *may* be grandfathered:

- Home mortgages
- Other secured loans
- Unsecured loans that are immaterial to your net worth

.93 Generally speaking, a loan may be grandfathered if you obtained it before:

1. You became a covered member with respect to the client.
2. The financial institution became a client.
3. The client acquired the loan.

.94 To maintain your loan's grandfathered status, you must keep the loan current (make timely payments according to the loan agreement). Also, you cannot renew or renegotiate the terms of the loan (for example, the interest rate or formula) unless the change was part of the original agreement (for example, an adjustable rate mortgage).

> The SEC rules differ from the AICPA rules in that secured loans (other than a mortgage on your primary residence) and immaterial unsecured loans may not be grandfathered.

May I Have a Brokerage Account With a Client?

.95

> Under the SEC rules, you may have a brokerage account with a client if your account (1) only holds cash or securities and (2) is fully insured by the Securities Investor Protection Corporation (SIPC).

May I Have a Bank Account With a Client?

.96 As a covered member, you may have a bank account with a client financial institution (for example, checking, savings, or money market accounts and certificates of deposit) if your deposits are fully insured by state or federal deposit insurance agencies or uninsured amounts are not material to your net worth.[10]

> The SEC prohibits covered persons and their immediate families from having bank account balances in excess of Federal Deposit Insurance Corporation (FDIC) insurance limits; that is, deposits in excess of FDIC limits are considered to impair independence, even if immaterial to you and your family.[11]

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[10] Both AICPA and SEC rules permit a practical exception for firms that maintain deposits exceeding insured limits when the likelihood of the financial institution experiencing financial difficulties is considered remote.

[11] The SEC treats money market *funds* (as opposed to money market *accounts*) as mutual funds for the purposes of their rules. Also, see Rule 2-01(c)(1)(B).

May I Have an Insurance Policy With a Client?

.97 The AICPA rules indicate that in order to maintain independence, a covered member must not receive any preferential treatment or terms when purchasing an insurance policy from a client. If the policy has an investment option, the financial interest rules must be applied.

> The SEC prohibits covered persons and their immediate family members from owning an individual insurance policy issued by a client unless both of the following criteria are met:
>
> - He or she obtained the policy before the professional became a covered person.
> - The likelihood of the insurer becoming insolvent is remote.

May I Give or Accept Gifts or Entertainment From a Client?

.98 An ethics ruling[12] addresses the exchange of gifts and entertainment between covered members, the client, and certain persons associated with the client (for example, persons in key positions and persons who are 10 percent or more stockholders of the client).

.99 Independence is impaired if the firm, a member of the attest engagement team, or a person able to influence the engagement accepts a gift that is not clearly insignificant.

.100 A covered member may give a gift to persons associated with the client and not impair independence if the gift is reasonable in the circumstances. In addition, covered members may give or receive entertainment, provided it was reasonable in the circumstances.

.101 Another ethics ruling[13] addresses the broader issue of integrity and objectivity when partners, professionals, or their firms exchange gifts or entertainment with clients or persons associated with clients. Generally, gifts are differentiated from entertainment by whether the client participates in the activity with the firm member (for example, giving tickets to a sporting event for the client to use would be considered a gift versus attending the event with the client, which would be considered entertainment).[14]

.102 Relevant factors in determining *reasonableness* include the event or occasion (if any) giving rise to the gift or entertainment, cost or value, frequency, whether business was conducted, and who participated.

Business Relationships

Which Business Relationships With a Client Impair Independence?

.103 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:

- Employee, director, officer, or in any management capacity
- Promoter, underwriter, or voting trustee
- Stock transfer or escrow agent

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[12] See Ethics Ruling No. 114, "Acceptance or Offering of Gifts and Entertainment to or From an Attest Client," of ET section 191.228–.229, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2).

[13] See Ethics Ruling No. 113, "Acceptance or Offering of Gifts or Entertainment" of ET section 191.226–.227, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2).

[14] See www.aicpa.org/download/ethics/Gifts_Basis_Document.pdf.

- General counsel (or equivalent)
- Trustee for a client's pension or profit-sharing trust

.104 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 impaired.

.105 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.

.106 There are two possible exceptions to this rule:

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 without impairing your independence if:
   a. Your position is purely honorary.
   b. You do not vote or participate in managing the organization.
   c. Your position is clearly identified as honorary in any internal and external correspondence.
2. In addition, you are also permitted to serve on a client's advisory board, provided all of the following criteria are met:
   a. The advisory board's function is purely advisory.
   b. The advisory board does not appear to make decisions for the client.
   c. The advisory board and any decision-making boards are separate and distinct bodies.
   d. Common membership between the advisory board and any decision-making groups is minimal.

.107 When evaluating your independence under this rule, you should examine the applicable board or committee charter to determine whether it is consistent with this ethics ruling.

> The SEC prohibits direct or material indirect business relationships with a client (or persons associated with a client), except when the firm is acting as a consumer in the ordinary course of business (for example, purchasing goods or services from a client at normal commercial terms where these goods or services will be consumed by the firm). Examples of prohibited business relationships are joint business ventures, limited partnership agreements, and certain leasing interests.

Nonattest Services

Which Rules Describe the Nonattest Services That My Firm and I May or May Not Provide to Attest Clients?

.108 The term *nonattest services* includes accounting and consulting services that are not part of an attest engagement.[15] Nonattest services specifically addressed in the rules are:

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[15] Defined in the AICPA *Code of Professional Conduct*, an attest engagement is one that requires independence under AICPA professional standards; for example, audits and reviews of financial statements or agreed-upon procedures performed under the attestation standards are considered attest engagements.

- Bookkeeping services
- Non-tax disbursement
- Internal audit assistance
- Benefit plan administration
- Investment advisory or management services
- Tax compliance services
- Corporate finance consulting or advisory services
- Appraisal, valuation, or actuarial services
- Executive or employee search services
- Business risk consulting
- Information systems design, installation, or integration
- Forensic accounting services

> In addition to considering the general standard and four guiding principals, the SEC rules prohibit or significantly restrict an accounting firm from providing the following services to an issuer contemporaneously with an audit:
>
> - Bookkeeping and other services related to the client's accounting records or financial statements
> - Financial information systems design and implementation
> - Appraisal or valuation services
> - Actuarial services
> - Internal audit outsourcing
> - Management functions
> - Human resources
> - Broker-dealer, investment adviser, or investment banking
> - Legal services
> - Expert services unrelated to the audit
> - Aggressive or confidential tax transactions (PCAOB)
> - Personal tax services provided to persons in financial reporting oversight roles (PCAOB)

.109 If your firm performs nonattest services for an attest client, the independence rules impose limits on the nature and scope of the services your firm may provide. In other words, the extent to which your firm may perform certain activities for the client may be limited by the rules. Further, certain services will be prohibited in total (for example, serving as a client's general counsel).

.110 This section does not discuss each of these services, but rather focuses on a few for purposes of illustration. To see the full context of the rules, see "Resource Central" at the end of this alert.

.111 The AICPA rules require a member to comply with more restrictive independence provisions, if applicable, of certain regulators, such as state boards of accountancy, the SEC, GAO, and DOL.

SEC and PCAOB rules require independence of the client and various affiliated entities.[16]

Note: SEC rules also require a client's audit committee (or equivalent) to preapprove all audit and nonaudit services provided by the firm to the audit client and the client's consolidated entities. Proposals to provide tax or internal control-related services are subject to more extensive audit committee preapproval requirements under PCAOB rules 3524, *Audit Committee Pre-approval of Certain Tax Services* (AICPA, *PCAOB Standards and Related Rules*), and 3525, respectively. (PCAOB Rule 3524 is currently effective; PCAOB Rule 3525 becomes effective for audits of fiscal years on or after November 15, 2007.)

AICPA General Requirements

.112 *General Requirement 1.* 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.

.113 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
- Establishing or maintaining internal controls, including monitoring ongoing activities.

.114 *General Requirement 2.* To help ensure compliance with General Requirement 1, the second requirement states that the client must agree to assume certain responsibilities related to the nonattest services engagement. So, prior to agreeing to perform any nonattest services for the client, the firm must obtain the client's agreement to:

1. Make all management decisions and perform all management functions.
2. Designate an individual who possesses suitable skill, knowledge, and experience, preferably within senior management, to oversee the services.
3. Evaluate the adequacy and results of the services performed.
4. Accept responsibility for the results of the services.

.115 With regards to Item 2 above, the firm should be satisfied that the client's designee understands the services to be performed sufficiently to oversee them. This does not mean that the individual must be able to perform or reperform the services, but he or she should be able to understand and agree to the nature, objectives, and scope of the services, make all significant judgments, evaluate the adequacy and results of the service, accept responsibility for the service results, and ensure that the resulting work product meets the agreed-upon specifications. The client must also be willing to commit the time and resources needed for the designee to fulfill these duties.

.116 *General Requirement 3.* Before performing nonattest services, the firm should establish and document its understanding with the client regarding the following:

[16] See Rule 2-01(f)(4) and (6).

1. Objectives of the engagement
2. Services to be performed
3. Client's acceptance of its responsibilities
4. Member's responsibilities
5. Any limitations of the engagement

.117 The firm should document the understanding in the engagement letter, audit planning memo, or other internal firm file.

> ***Note:*** Routine activities (for example, assisting clients with technical accounting questions, advising on internal controls, or providing periodic training on new pronouncements) that are part of the normal auditor-client relationship are exempt from the second and third general requirements.

What Are the Rules on Performing Bookkeeping Services for a Client?

.118 The AICPA independence rules prohibit members from acting as client management in all circumstances. Accordingly, a member may provide bookkeeping services, provided the client oversees the services and, among other things, performs all management functions and makes all management decisions in connection with the services. For example, if a member is engaged to provide bookkeeping services that will result in a set of financial statements, the client must:

- Approve all account classifications.
- Provide source documents to the member so that the member can prepare journal entries.
- Take responsibility for the results of the member's services (for example, financial statements).

> ***Note:*** Proposing adjusting entries to financial statements as a part of the member's audit, review, or compilation services is a normal part of those engagements and would not be considered the performance of a nonattest service subject to the general provisions of Interpretation No. 101-3. However, the client should review these entries, understand the impact on the financial statements, and, if they agree that they are appropriate, record the adjustments identified by the member.

> Because of self-audit concerns, performing any type of bookkeeping service for a client (or affiliate of a client) is considered to impair independence under SEC rules, unless it is reasonable to expect that the results of the auditor's services will not be subject to the firm's audit procedures. The SEC considers there to be a rebuttable presumption that the results of these services would be subject to audit procedures and, therefore, the firm must overcome the presumption to perform the service.
>
> This presumption of self-audit also applies to (1) financial information design and implementation; (2) appraisals, valuations, fairness opinions, or contribution-in-kind reports; (3) actuarial-related advisory services; and (4) internal audit outsourcing.
>
> In August 2007, the SEC staff updated its FAQ document entitled, *Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions*. FAQ 7 under "Prohibited and Non-audit Services" addressed the question of whether a successor auditor who performed one of the above services during the audit period (that is, period covered by the financial statements) would be independent of the client. The FAQ states that if the services (*a*) relate solely to the prior period audited by the predecessor auditor and (*b*) were performed before the successor auditor was engaged to audit the current audit period, independence would not be impaired.

May My Firm Provide Internal Audit Assistance to a Client?

.119 To perform internal audit assistance for a client and maintain independence, your firm may not act—or appear to act—as a member of the client's management. For example, you and your firm may not:

- Make decisions on the client's behalf.
- Report to the client's governing body.

.120 To maintain independence, the client must:

- Designate an individual or individuals who possess suitable skill, knowledge, and experience to oversee the internal audit function.
- Determine the scope, risk, and frequency of internal audit activities.
- Evaluate the findings and results of internal audit activities.
- Evaluate the adequacy of the audit procedures performed and related findings.

> Internal audit services impair independence under SEC rules unless it is reasonable to expect that the results of the auditor's services would not be subject to the firm's audit procedures.

Note: For entities regulated by the FDIC or other banking agencies, see www.fdic.gov/news/news/financial/2003/fil0321.html.

May My Firm Provide Valuation, Appraisal, or Actuarial Services to a Client?

.121 Your firm may not provide valuation, appraisal, or actuarial services for a client if:

- The results of the service would be material to the client's financial statements; and
- The service involves a significant amount of subjectivity.

.122 For instance, your firm may not perform a valuation in connection with a business combination that would have a material effect on a client's financial statements because that service generally involves significant subjectivity (for example, setting the assumptions and selecting and applying the valuation methodology).

.123 There are two limited exceptions to this rule. Valuation, appraisal, or actuarial services performed for *nonfinancial statement purposes* may be provided if they otherwise meet the rule's general requirements (for example, the client assigns an individual to oversee the service who is in a position to make an informed judgment on and accept responsibility for the results of the service). Also, your firm may provide an actuarial valuation of a client's pension or postretirement liabilities because the results of the valuation would be reasonably consistent regardless of who performs the valuation.

> The SEC prohibits your firm from providing valuation, appraisal, or *any* service involving a fairness opinion or contribution-in-kind report[17] to clients *unless* it is reasonable to expect that your firm would not audit the results of those services.

May My Firm Provide Investment Advisory Services to a Client?

.124 Here are examples of what you and your firm may do under the AICPA rules:

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[17] Per the SEC, fairness opinions and contribution-in-kind reports are opinions and reports in which your firm provides its opinion on the adequacy of consideration in a transaction.

- Make recommendations to a client about the allocation of funds to various asset classes.
- Analyze investment performance.

.125 However, the AICPA rules also indicate that you and your firm may not:

- Make investment decisions for the client.
- Execute investment transactions.
- Take custody of a client's assets.

May My Firm Design or Implement an Information System for a Client?

.126 Your firm may not design or develop a client's financial information system or make more than insignificant modifications to the source code underlying such a system. In addition, operating a client's local area network (LAN) is prohibited.

.127 Your firm may install an accounting software package for a client, including helping the client set up a chart of accounts and financial statement format. Your firm may also provide training to the client's employees on how to use an information system. Your firm may not, however, supervise the client's employees in their day-to-day use of the system, since that activity is a management function.

.128 Your firm is not precluded from designing, implementing, integrating, or installing an information system that is unrelated to the client's financial reporting process.[18]

> SEC rules prohibit your firm from providing any service related to a client's financial information system design or implementation *unless* the results of your firm's services would *not* be subject to audit procedures during an audit of the client's financial statements. Your firm may either:
>
> - Evaluate internal controls underlying the client's financial information system as it is being designed, implemented, or operated for the client by another service provider.
> - Make recommendations on internal control matters to management in connection with a system design and implementation project being performed by another service provider.
>
> ***Note:*** Effective for audits of fiscal years ending on or after November 15, 2007, your firm must obtain preapproval for these and other internal control-related services in accordance with Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting*.

Fee Issues

What Types of Fee Arrangements Between My Firm and a Client Are Prohibited?

.129 Two types of fee arrangements, contingent fees and commissions, are prohibited if the arrangement involves certain attest clients, even though the fee is not related to an attest service.

.130 A contingent fee is an arrangement whereby (1) no fee is charged unless a specified result is attained or (2) the amount of the fee depends on the results of your firm's services. Some examples of contingent fees are:

[18] An FAQ to assist members in understanding and implementing the new information technology services provisions may be obtained at www.aicpa.org/download/ethics/QA_IT.pdf.

- 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.

.131 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

.132 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.

.133 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.

.134 Commissions or contingent fee arrangements with a client are not allowed if your firm also provides one of the following services to a client:

- An audit of financial statements
- A review of financial statements
- A compilation of financial statements if 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

.135 You 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 an attest client). For example, you may receive a commission from a nonclient insurer if you refer an officer of an attest client to the insurer and the officer purchases a policy. Even though this situation is permitted, you are still required to tell the officer that you received a commission for making the referral.

> ***Note:*** State boards of accountancy and state societies may also have more restrictive regulations regarding fee arrangements, as well as specific disclosure requirements.

PCAOB Rule 3521, *Contingent Fees*, (AICPA, *PCAOB Standards and Related Rules*) prohibits you and your firm from providing any service or product to an audit client for a contingent fee or a commission, or receiving from the audit client, directly or indirectly, a contingent fee or commission. Although the PCAOB's definition of contingent fees was adapted from the SEC's definition, the PCAOB rule eliminated the exception for fees in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. In addition, the PCAOB rule specifically indicates that the contingent fees cannot be received directly or indirectly from the audit client. PCAOB Rule 3521 does not apply to contingent fee arrangements that were paid in their entirety, converted to fixed fee arrangements, or otherwise unwound before June 18, 2006.

.136 If a client owes your firm fees for services rendered more than one year ago, your firm's independence is considered impaired. It does not matter whether or not the services were for attest services; what matters is that the client has an outstanding debt with the firm. This is the case even if the client has given you a note receivable for these fees.

> The SEC generally expects payment of past-due fees before an engagement has begun, although a short-term payment plan may be accepted if the client has committed to pay the balance in full before the current year report is issued.[19]

When Are Referral Fees Permitted?

.137 The AICPA rule provides that a CPA who (1) accepts a referral fee for recommending or referring any service of a CPA to any person or entity or (2) pays a referral fee to obtain a client shall disclose such acceptance or payment to the client receiving the referral.

Does Being Compensated for Selling Certain Services to Clients Affect My Independence?

.138 The AICPA rules do not specifically address this issue.

> The SEC prohibits audit partners from being *directly* compensated for selling nonattest services to audit clients. The SEC believes that such financial incentives could threaten an audit partner's objectivity and that the appearance of independence could be affected by such compensation arrangements.[20]
>
> The rule does not prevent an audit partner from sharing in profits of the audit practice or the overall firm. Nor does it preclude the firm from evaluating a partner based on factors *related* to the sale of nonaudit services to clients (for example, the complexity of engagements or overall management of audit or nonaudit engagements).

Does It Matter If a Significant Proportion of My Firm's Fees Come From a Particular Client?

.139 The "Conceptual Framework for AICPA Independence Standards" states that a financial self-interest threat may exist due to "excessive reliance on revenue from a single attest client." In addition, Rule 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 102), and Rule 55, *Article IV—Objectivity and Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 55), discuss in broad terms that members should be alert for relationships that could diminish their objectivity and independence in performing attest services. The significance of a client to a member (or his or her firm)—measured in terms of fees, status, or other factors—may diminish a member's ability to be objective and maintain independence when performing attest services.

.140 To address this issue, firms should consider implementing policies and procedures to identify and monitor significant clients to help mitigate possible threats to a member's objectivity and independence:

1. Policies and procedures for identifying and monitoring significant client relationships include:
   — Considering client significance in the planning stage of the engagement

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[19] The exception has generally been applied only to engagements to audit a client's financial statements included in its annual report, not in a registration statement.

[20] Accounting firms with 10 or fewer partners and 5 or fewer audit clients that are *issuers*, as defined by the SEC, are exempt from this rule.

— Basing the consideration of client significance on firm-specific criteria or factors that are applied on a facts and circumstances basis (see the following section entitled "Factors to Consider in Identifying Significant Clients")

— Periodically monitoring the relationship

What constitutes *periodic* is a matter of judgment but assessments of client significance that are performed at least annually can be effective in monitoring the relationship. During the course of such a review, a client previously deemed to be significant may cease to be significant. Likewise, clients *not* identified as significant could become significant whenever factors the firm considers relevant for identifying significant clients arise (for example, additional services are contemplated).

2. Policies and procedures to help mitigate possible threats to independence and objectivity by:

— Assigning a second (or concurring) review partner who is not otherwise associated with the engagement and practices in an office other than that which performs the attest engagement

— Subjecting the assignment of engagement personnel to approval by another partner or manager

— Periodically rotating engagement partners

— Subjecting significant client attest engagements to internal firm monitoring procedures

— Subjecting significant client attest engagements to preissuance or postissuance reviews or to the firm's external peer review process

.141 The most effective safeguards a firm can employ will vary significantly depending on the size of the firm, the way the firm is structured (for example, whether highly centralized or departmentalized), and other factors. For example, smaller firms (particularly those with one office) tend to be simpler and less departmentalized than larger firms. Generally, their processes will be less formal and involve fewer people than larger firms. Further, their firms' managing partners may engage in frequent and direct communications with the firms' partners and professional staff on client matters and be personally involved in staff assignments. Larger firms draw from a sizeable and diverse talent pool. In those firms, partners who are not affiliated with the engagement (or the client service office or business unit) can choose second (or concurring) review partners from outside the office performing the attest engagement. Mid-sized—or regional—firms may have aspects of both their smaller and larger counterparts (for example, combining the ability to choose second-review partners from an office other than the client service office, while maintaining a relatively close connection to specific client relationships).

Factors to Consider in Identifying Significant Clients

.142 Both qualitative and quantitative factors can reveal a significant client, including:

- The size of the client in terms of the percentage of fees or the dollar amount of fees versus total revenue of the engagement partner, office, practice unit,[21] or the firm
- The significance of the client to the engagement partner, office, or practice unit of the firm in light of the:

— Amount of time the partner, office, or practice unit devotes to the engagement

— Effect on the partner's stature within the firm due to his or her's servicing of the client

— Manner in which the partner, office, or practice unit is compensated

— Effect that losing the client would have on the partner, office, or practice unit

[21] Assessing client significance at the business or practice unit level may be a more meaningful measure for firms that structure their practices along industry lines (such as health care or financial services).

- The importance of the client to the firm's growth strategies (for example, the firm is trying to gain entry into a particular industry)
- The stature of the client, which may enhance the firm's stature (for example, the client is a company of distinction within its industry, or in the local, regional, national, or international business community)
- Whether the firm also provides services to related parties (for example, also provides professional services to affiliates or owners of the client)
- Whether the engagement is recurring or not

.143 Judgment is necessary to determine whether a client is significant to the firm, office, practice unit, or partner of the firm. Firms will vary considerably in terms of the degree to which they consider some factors to be more pertinent than others. Gauges that relate to each relevant level within a firm (for example, firm, geographic region, office, practice unit, or partner), may be useful, but will likely be different for various levels within the firm.

> According to SEC guidance, in general, if a firm derives more than 15 percent of its total revenues from one client or group of related clients, independence may be impaired because this may cause the firm to be overly dependent on the client or group of related clients.

Other Guidance

Where Can I Find Further Assistance With My Independence and Ethics Questions?

.144 This section of the alert does not address many subjects included in the AICPA rules. Readers are encouraged to view the online version of the *Code of Professional Conduct* at www.aicpa.org/about/code/index.html.

What Should I Do If No Specific Guidance Exists on My Particular Independence Issue?

.145 The "Other Considerations" section of Interpretation No. 101-1, "Interpretation of Rule 101" under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02), recognizes that it is impossible for the Code to identify all circumstances in which the appearance of independence might be questioned. The Conceptual Framework is referred to in the "Other Considerations" of Interpretation No. 101-1 of the Code.

.146 Specifically, Interpretation No. 101-1 requires that members use the risk-based approach described in the Conceptual Framework when making independence decisions involving matters that are not specifically addressed in the independence interpretations and rulings in the Code. Where threats to independence are not at an acceptable level, safeguards must be applied to eliminate the threats or reduce them to an acceptable level. In cases where threats to independence are not at an acceptable level, thereby requiring the application of safeguards, the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level must be documented.

.147 The Conceptual Framework provides a valuable tool to help you in complying with the requirement in the "Other Considerations" section to evaluate whether a specific circumstance that is not addressed in the Code would pose an unacceptable threat to your independence. These new provisions became effective for all independence decisions made after April 30, 2007.

Resource Central

Independence and Ethics Contact List

.148 As specific services and situations arise in practice, refer to the independence literature and consult with those responsible for independence in your firm. If you need further assistance researching your question, contact one of the following organizations for guidance:

AICPA

.149 The AICPA has a variety of resources for practitioners:

- The Web site address for information about the AICPA's ethics standard-setting activities is www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/Exposure+Drafts+-+Standard+Setting/.
- For resources related to understanding and applying nonattest services rules, see www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/Resources+and+Tools/Guidance+on+Understanding+and+Implementing+Rule+101-3+Independence+and+Non-Attest+Services.htm.
- The Code is available at www.aicpa.org/about/code/index.html.
- For independence inquiries by phone, call (888) 777-7077. Send e-mail inquiries to ethics@aicpa.org.

SEC

.150 The SEC provides guidance on requirements for issuers:

- The SEC's January 2003 rules release is available at www.sec.gov/rules/final/33-8183.htm.
- SEC information for accountants and auditors, including independence, may be found at www.sec.gov/about/offices/oca/ocaprof.htm.
- U.S. Securities and Exchange Commission, Office of the Chief Accountant, 100 F Street NE, Washington, DC 20549; (202) 551-5300 (phone); (202) 772-9252 (fax).

PCAOB

.151 The PCAOB has established a Web site at www.pcaob.org, which provides information about its activities. The standards and rules of the PCAOB, including those on independence, can be found at www.pcaob.org/Standards/Standards_and_Related_Rules/index.aspx.

GAO

.152 The GAO provides guidance for audits conducted in accordance with *Government Auditing Standards*, including:

- Yellow Book Independence Standard (see www.gao.gov/govaud/ybk01.htm)
- Answers to frequently asked independence questions (see www.gao.gov/govaud/d02870g.pdf)
- Slide presentation on independence standard (www.gao.gov/govaud/niaf021025.pdf)
- Direct inquiries to Michael Hrapsky, Senior Project Manager—Government Auditing Standards at (202) 512-9535 or e-mail yellowbook@gao.gov

DOL

.153 See DOL Regulation 2509.75-9, Interpretive Bulletin Relating to Guidelines on Independence of Accountant Retained by Employee Benefit Plan. You may direct inquiries to the DOL at (866) 4-USA-DOL.

Federal Deposit Insurance Corporation

.154 You can obtain Federal Deposit Insurance Corporation regulations (12 CFR Part 363), *Annual Independent Audits and Reporting Requirements*, at www.fdic.gov/regulations/laws/rules/2000-8500.html. A 2006 advisory regarding the use of limitation of liability provisions in engagement letters with public and nonpublic financial institutions is available at www.federalreserve.gov/boarddocs/srletters/2006/SR0604a1.pdf.

Continuing Professional Education

.155 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs. Among the available titles, the following self-study courses pertain to independence and ethics:

- *Independence* (product no. 739177HSkk)
- *Selected Topics in Professional Ethics* (product no. 738382HSkk)
- *Professional Ethics: AICPA's Comprehensive Course* (product no. 732310kk)
- *Ethics: Non-Attest Services, Integrity and Objectivity* (product no. 739411HSkk)
- *Ethics for Tax Practice Professionals: Circular 230 and the SSTSs* (product no. 738700HSkk)
- *Professional Ethics for CPAs in Business & Industry* (product no. 738900kk)
- *Real World Business Ethics for CPAs in A&A: How Will You React?* (product no. 733600kk)
- *Real World Business Ethics for CPAs in Business & Industry: How Will You React?* (product no. 733590kk)

Online CPE

.156 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 for a new subscription and $119 for the annual renewal. Nonmembers pay $369 for each. Divided into one- and two-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics that address ethics and independence issues are:

- *2007 Annual Update-A&A: Issues for Audits of Public Entities on the Horizon*
- *In a CPA's Professionalism We Must Trust*
- *Ethics: Pointer Electronics, Inc.—You Are the Audit Partner*
- *Ethics: Superlative Software, Corp. —You Are the CFO*
- *Yellow Book: Ethical Principles and General Standards*

.157 To register or learn more, visit www.cpa2biz.com.

Publications

.158 Practitioners may find the following publications useful when considering independence and ethics issues:

- *Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Requirements* (product no. 006627kk)
- *Independence Compliance: Checklists and Tools for Complying with AICPA, SEC, and PCAOB Independence Requirements* (product no. 006630kk)

Webcasts

.159 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high-quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM. Additional information can be found at www.cpa2biz.com.

CFO Quarterly Roundtable Series

.160 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.161 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.162 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.163 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, 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 the answer. You can reach the Technical Hotline at (888) 777-7077.

Ethics Hotline

.164 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.

AICPA Governmental Audit Quality Center

.165 The Governmental Audit Quality Center (GAQC) is a firm-based, voluntary membership Center designed to help CPAs meet the challenges of performing quality audits in this unique and complex area. The GAQC's primary purpose is to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The GAQC also offers resources to enhance the quality of a firm's governmental audits.

.166 The mission of the Governmental Audit Quality Center is to:

- Raise awareness about the importance of governmental audits.
- Serve as a comprehensive resource provider on governmental audits for member firms.
- Create a community of firms that demonstrates a commitment to governmental audit quality.
- Provide center members with an online forum tool for sharing best practices as well as discussions on audit, accounting, and regulatory issues.
- List member firms to enable purchasers of governmental audit services to identify firms that are members.
- Provide information about the center's activities to other governmental audit stakeholders.

.167 For more information about the GAQC visit gaqc.aicpa.org.

AICPA Center for Audit Quality

.168 The CAQ (formerly the Center for Public Company Audit Firms [CPCAF]) was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.169 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ visit thecaq.aicpa.org.

AICPA Employee Benefit Plan Audit Quality Center

.170 The Employee Benefit Plan Audit Quality Center (EBPAQC) is a voluntary membership organization for firms that perform or are interested in performing ERISA employee benefit plan audits. The EBPAQC was established to promote the quality of employee benefit plan audits.

.171 To achieve this goal, the EBPAQC has created a community of firms that demonstrate a commitment to employee benefit audit quality, and supports those firms by:

- Providing members with timely communication of regulatory developments, best practices guidance, and technical updates.
- Providing members with an online community forum for sharing best practices as well as discussions on audit, accounting, and regulatory issues.

- Maintaining relationships with, and acting as a liaison to, the DOL on behalf of member firms.
- Providing center members with a marketing toolkit to facilitate promotion of their membership in the center.
- Providing information about the center's activities to other employee benefit plan stakeholders.

.172 The increasing complexity of employee benefit plan auditing and increased scrutiny by the DOL have resulted in a significant number of changes and issues for auditing firms and CPAs in general. Firms and CPAs will benefit from the assistance of the Center as a resource for improving employee benefit plan audit quality.

.173 For more information about the EBPAQC, visit http://ebpaqc.aicpa.org.

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.174 This Audit Risk Alert replaces *Independence and Ethics Alert—2006/07*.

.175 The Audit Risk Alert *Independence and Ethics Alert* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to ccole@aicpa.org or write to:

Christopher Cole, CPA CFE
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

[*The next page is 9000-91*.]

AAM Section 8260
SEC and PCAOB Alert—2007/08

A ROUNDUP OF RECENT SEC AND PCAOB RULES AND DEVELOPMENTS OCCURRING DURING 2007, THROUGH THE DATE OF THIS PUBLICATION, AND DURING THE FOURTH QUARTER OF 2006

Kristy L. Illuzzi, CPA
Technical Manager
Accounting and Auditing Publications

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Securities and Exchange Commission Developments

.01 The summaries below are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable rule or development. In addition, the information presented below does not encompass all of the recent issuances and activities of the U.S. Securities and Exchange Commission (SEC). See the SEC Web site at www.sec.gov for complete information.

SEC Final Rules

Definition of a Significant Deficiency

.02 On August 3, 2007, the SEC posted a final rule whereby it defined the term *significant deficiency* for the purpose of implementing Section 302 and Section 404 of the Sarbanes-Oxley Act of 2002. The term is defined as "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting." The full text of this rule can be found at www.sec.gov/rules/final/2007/33-8829.pdf.

Executive Compensation Disclosure

.03 The SEC issued Release Nos. 33-8765 and 34-55009 on December 22, 2006, in which they adopted, as interim final rules, amendments to the disclosure requirements for executive and director compensation. The amendments to Item 402 of Regulation S-K and S-B revise the Summary Compensation Table and Director Compensation Table disclosure with respect to stock awards and option rewards to provide disclosure of the compensation cost of awards over the requisite service period, as described in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*. The amendments revise the Grants of Plan-Based Awards Table to include information concerning repriced or materially modified options, stock appreciation rights, and similar option-like instruments, disclosing the incremental fair value computed as of the repricing or modification date. The amendments to the Director Compensation Table require footnote disclosure corresponding to the new Grants of Plan-Based Awards Table fair value disclosures. The amendments are intended to provide investors with more complete and useful disclosure about executive compensation. These releases are effective December 29, 2006. The complete text of the final releases can be found at www.sec.gov/rules/final/2006/33-8765.pdf.

Internal Control Over Financial Reporting in Securities Exchange Act of 1934 Periodic Reports of Nonaccelerated Filers or Newly Public Companies

.04 The SEC issued a final rule on December 15, 2006, further extending the dates for which smaller public companies and newly public companies must comply with internal control reporting requirements mandated under Section 404 of the Sarbanes Oxley Act of 2002. Under this new rule, a nonaccelerated filer is not required to provide management's report on internal control over financial reporting until it files an annual report for its first fiscal year ending on or after December 15, 2007. A nonaccelerated filer is also not required to file the auditor's attestation report on internal control over financial reporting until it files an annual report for its first fiscal year ending on or after December 15, 2008. In response to inquiries from the SEC commissioners regarding the possibility of further extensions of compliance dates for small businesses, the staff indicated that they do not believe there is a need to extend the compliance date for management's assessment required by Section 404(a). With respect to Section 404(b), the SEC staff stated that while no extension is planned at this time, they will continue to monitor compliance by larger companies to determine whether further extensions are warranted. The SEC is also adopting amendments that provide for a transition period for a newly public company before it becomes subject to the internal control over financial reporting requirements. The complete text of the rule can be found at www.sec.gov/rules/final/2006/33-8760.pdf.

Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting (Technical Amendment, Corrected)

.05 On June 20, 2007, the SEC posted an amendment to its rules to clarify that an evaluation of internal control over financial reporting that complies with the SEC's interpretive guidance published in Release No. 34-55929 is one way to satisfy the requirement for management to evaluate the effectiveness of the issuer's internal control over financial reporting. The SEC has also amended its rules to define the term *material weakness* and to revise the requirements regarding the auditor's attestation report on the effectiveness of internal control over financial reporting. The amendments are intended to facilitate more effective and efficient evaluations of internal control over financial reporting by management and auditors. Access www.sec.gov/rules/final/2007/33-8809.pdf for the entire release. See the "PCAOB Approved Rules and Standards" section of this alert (paragraphs .49–.58) for more information on Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), which was approved by the SEC in July 2007.

SEC Interpretive Releases

Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting

.06 The SEC posted Interpretive Release No. 33-8810 and 34-55929 on June 20, 2007, to provide guidance for management regarding its evaluation and assessment of internal control over financial reporting. This guidance is organized around two broad principles. The first principle is that management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner. This guidance describes a top-down, risk-based approach to this principle. The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. This guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation. More specifically, this interpretive guidance does the following:

- Explains how to vary evaluation approaches for gathering evidence based on risk assessments
- Explains the use of "daily interaction," self-assessment, and other ongoing monitoring activities as evidence in the evaluation
- Explains the purpose of documentation and how management has flexibility in documenting support for its assessment
- Provides management significant flexibility in making judgments regarding what constitutes adequate evidence in low-risk areas
- Allows for management and the auditor to have different testing approaches

.07 The text of the full interpretation can be found at www.sec.gov/rules/interp/2007/33-8810.pdf.

SEC No-Action and Exemptive Orders

.08 The SEC issues Securities Exchange Act of 1934 no-action and exemptive orders, both of which are typically in response to an inquiry from a public company. Exemptive orders are similar to no-action letters in that they provide a green light from the SEC to move forward on a new initiative. However, exemptive orders apply only to the situation for which they are granted. No-action letters may be relied upon by other firms as precedent. Recently issued no-action and exemptive orders can be found at www.sec.gov/interps/noaction.shtml.

SEC Proposed Rules

Smaller Reporting Company Regulatory Relief and Simplification

.09 On July 5, 2007, the SEC proposed rule amendments relating to disclosure and reporting requirements for smaller companies under the Securities Act of 1933 and the Securities Exchange Act of 1934. Further details regarding this proposed rule can be found in the "SEC Small Business Initiatives" section of this alert (paragraphs .34–.40).

Acceptance From Foreign Private Issuers of Financial Statements Prepared in Accordance With International Financial Reporting Standards Without Reconciliation to U.S. Generally Accepted Accounting Principles

.10 On July 2, 2007, the SEC proposed to accept from foreign private issuers their financial statements prepared in accordance with International Financial Reporting Standards (IFRS) without reconciliation to

U.S. generally accepted accounting principles (GAAP). To implement this, the SEC has proposed amendments to Form 20-F and conforming changes to Regulation S-X to accept financial statements prepared in accordance with the English language version of IFRS as published by the International Accounting Standards Board (IASB) without reconciliation to U.S. GAAP when contained in the filings of foreign private issuers with the SEC. Current requirements regarding the reconciliation to U.S. GAAP will not change for foreign private issuers that use a basis of accounting other than the English language version of IFRS. The full text of this release can be viewed at www.sec.gov/rules/proposed/2007/33-8818.pdf.

Revisions to Rules 144 and 145 to Shorten Holding Period for Affiliates and Nonaffiliates

.11 On June 22, 2007, the SEC proposed a 6-month holding period under Rule 144 (the "safe harbor" rule) for restricted securities of companies that are subject to the reporting requirements of the Securities Exchange Act of 1934. Additional information regarding this proposal can be found in the "SEC Small Business Initiatives" section of this alert (paragraphs .34–.40).

SEC Concept Releases

Allowing U.S. Issuers to Prepare Financial Statements in Accordance With IFRS Standards

.12 On August 7, 2007, the SEC published a concept release to obtain information about the extent and nature of the public's interest in allowing U.S. issuers, including investment companies subject to the Investment Company Act of 1940, to prepare financial statements in accordance with IFRS. Comments are due by November 13, 2007. The full text of this release, as well as information on where to submit comments, can be found at www.sec.gov/rules/concept/2007/33-8831.pdf.

SEC Staff Accounting Bulletins

.13 A Staff Accounting Bulletin (SAB) reflects the SEC staff's views regarding accounting-related disclosure practices. They represent interpretations and policies followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the disclosure requirements of the federal securities laws. There have been no additional SAB's issued since the last publication of this Audit Risk Alert. The most recent SAB issued was SAB No. 108, Topic 1N, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, on September 13, 2006. For a listing of the most recent SAB issuances, see www.sec.gov/interps/account.shtml.

SEC Office of the Chief Accountant: Staff Letters to Industry

.14 Readers should be aware of the following staff letters to industry that provide helpful guidance and clarification regarding the SEC staff's interpretation of certain accounting issues and their application under U.S. GAAP.

Letter From SEC Chief Accountant to Council of Institutional Investors Concerning the Use of Market Instruments for the Purpose of Valuing Employee Share-Based Payment Awards Under FASB Statement No. 123R (February 23, 2007)

.15 This letter points out that while the best evidence of fair value for employee stock options is observable market prices of identical or similar instruments in active markets, the FASB did not provide detailed guidance on how one might comply with this principles-based objective. The SEC staff noted that factors to consider when applying FASB Statement No. 123R include the size of the offering relative to market demand, the number and characteristics of bidders, the functionality of the technology, and purchaser perceptions concerning costs of holding, hedging, or trading the instrument. The full text of the letter can be found at www.sec.gov/info/accountants/staffletters/cii022307.htm.

Letter From SEC Chief Accountant to Zions Bancorporation Concerning Its Proposal to Issue Employee Stock Option Appreciation Rights Securities for the Purpose of Valuing Employee Share-Based Payment Awards Under FASB Statement No. 123R (January 25, 2007)

.16 This letter provides guidance regarding Employee Stock Option Appreciation Rights Securities instruments and whether they are sufficiently designed to be used as a market-based approach under FASB Statement No.123R. The full text of the letter can be accessed at www.sec.gov/info/accountants/staffletters/zions012507.pdf.

Recent Guidance Provided by the SEC's Division of Corporation Finance

.17 Readers should be aware of the current accounting and disclosure issues document prepared by the staff of the Division of Corporate Finance available at www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf, which was last updated on November 30, 2006. The updated document contains references to new and updated items that were recently incorporated into the document. The items recently incorporated as new (as opposed to updated) current accounting and disclosure items are in the following areas:

- Final rules regarding executive compensation
- Accounting for employee stock options
- Quantifying misstatements
- Final rule regarding tender offer-best price rule
- Rule proposal related to Foreign Private Issuer deregistration
- Electronic access to comment and response letters and electronic notifications of effectiveness
- Five recent enforcement actions involving U.S. GAAP
- Adoption of a new accounting standard in an interim period
- Statement of cash flows (discontinued operations and insurance proceeds)
- Discussion in Management's Discussion and Analysis of contingencies, loss reserves, and uncertain tax positions
- Segment disclosure (operating segments and goodwill impairment)
- Shortcut method of assessing hedge effectiveness
- Disclosure of off-balance sheet arrangements
- Disclosure of liability for unpaid claims and claims adjustment expenses and reinsurance recoverables on paid and unpaid claims

.18 The items incorporated as updated (as opposed to new) current accounting and disclosure issues are in the following areas:

- Final rules regarding use of Form S-8, Form 8-K, and Form 20-F by public shell companies
- Rules and concept release regarding the use of tagged data and incentives to voluntarily submit Extensible Business Reporting Language (XBRL) information
- Accelerated filer definitions and deadlines for filing periodic reports
- Management's report on internal control over financial reporting and certification of disclosure in Securities Exchange Act of 1934 periodic reports

- One recent enforcement action involving U.S. GAAP
- Classification and measurement of warrants and embedded conversion features
- Statement of Cash Flows
- Oil and gas industry issues
- Revenue (buy/sell arrangements)
- Investments and other-than-temporary declines in value
- Contingencies, loss reserves, and uncertain tax positions
- Segment disclosure (aggregation of operating segments)
- Financial statement presentation and disclosure under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
- Corporation finance staffing and phone numbers
- Division employment opportunities (professional academic fellowships)

Updated Frequently Asked Questions Regarding Management's Report on Internal Control Over Financial Reporting

.19 On September 24, 2007, the SEC revised their frequently asked questions (FAQs) document related to management's report on internal control over financial reporting and certification of disclosure in Securities Exchange Act of 1934 periodic reports. The SEC noted that these revisions were made to eliminate FAQs that the staff believed were no longer relevant, necessary, or were addressed by the SEC's issuance of Interpretive Guidance for Management on May 23, 2007 (Release No. 33-8810).

.20 The specific changes that were made resulted in the elimination of previously existing FAQs numbered 5, 7, 10–13, and 15–20. The remaining FAQs are substantially the same and have been renumbered as a result of the elimination of the 12 previously referenced FAQs. In addition, four new FAQs have been added pertaining to foreign private issuers. Please note that these FAQs represent the views of the staffs of the Office of the Chief Accountant and the Division of Corporation Finance. They are not rules, regulations, or statements of the SEC. Further, the SEC has neither approved nor disapproved them.

.21 The updated FAQs can be found at www.sec.gov/info/accountants/controlfaq.htm.

Accounting Guidance to Certain Registrants in the Form of Sample Letters

.22 In February 2005, the staff of the Division of Corporation Finance publicly posted sample letters sent to certain registrants to promote widespread awareness of certain accounting issues and to provide examples of comments that other registrants should consider as they prepare future SEC filings, as applicable. A number of letters have been posted. Below is one letter related to stock options. There are other letters posted related specifically to oil and gas, coal mining, and banking industries. Readers who are involved in those industries may want to review this additional guidance, which can be found at www.sec.gov/divisions/corpfin/cfreportingguidance.shtml.

.23 *Sample letter sent in response to inquiries related to filing restated financial statements for errors in accounting for stock option grants*. In December 2006, the Division of Corporation Finance responded to inquiries from several public companies requesting filing guidance as they prepare to restate previously issued financial statements for errors in accounting for stock option grants. The full text of the sample letter can be found at www.sec.gov/divisions/corpfin/guidance/oilgasltr012007.htm.

Staff Observations in the Review of IFRS Financial Statements and on Annual Reports Containing Financial Statements Prepared for the First Time on the Basis of IFRS Standards

.24 In 2006, the SEC staff reviewed the annual reports of more than 100 foreign private issuers containing financial statements prepared for the first time on the basis of IFRS. The staff comments include the following topics:

- Assertion of compliance with IFRS
- Manner of presentation
- Topical areas, including revenue recognition, intangible assets and goodwill, impairment of long-lived assets, leases, contingent liabilities, and financial instruments

.25 The full text of the staff observations along with other IFRS information can be found at www.sec.gov/divisions/corpfin/cfreportingguidance.shtml.

Recent Guidance Provided by the SEC's Division of Investment Management

.26 The SEC's Division of Investment Management regulates investment companies, such as mutual funds, closed-end funds, unit investment trusts, exchange-traded funds, and interval funds, including variable insurance products, and federally registered investment advisors. It has recently issued the guidance discussed in the following paragraph.

Staff Interpretive Guidance on Implementation of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109

.27 The Division of Investment Management staff has issued a letter, dated June 28, 2007, in response to a request for additional guidance regarding interpretive guidance on FASB Interpretation No. 48. The letter specifically addresses how to deal with provisions for adequate time to allow for proper accruals, as well as the impact of accruals on net asset values of investments. The letter can be accessed at www.sec.gov/divisions/investment/fin48_letter_062807.htm.

.28 In addition, the staff issued a letter dated December 22, 2006, regarding the application of FASB Interpretation No. 48 to the fund industry and specific challenges to this industry. For further guidance and a copy of the letter, see www.sec.gov/divisions/investment/letter_mutual_fund_fin_48.htm.

.29 Other Division of Investment Management guidance can be accessed at www.sec.gov/divisions/investment/guidance.shtml.

SEC Independence Initiatives

SEC Updates FAQs on Auditor Independence

.30 On August 6, 2007, the SEC updated its FAQs guidance related to the application of the SEC's rules on auditor independence. Specifically, the SEC issued new FAQs on the following topics:

- Prohibited and nonaudit services
- Audit committee preapproval
- Fee disclosures
- "Cooling off" period

.31 The complete set of updated FAQs can be accessed at www.sec.gov/info/accountants/ocafaqaudind080607.htm.

SEC Brochure on Audit Committees and Auditor Independence

.32 The SEC recently posted to its Web site a useful document related to audit committees and auditor independence. The purpose of this brochure is to highlight certain SEC rules and other authoritative pronouncements relevant to audit committee oversight responsibilities regarding the auditor's independence. The brochure specifically highlights the following:

- General standard of auditor independence
- Specific prohibited nonaudit services
- Preapproval of permitted services
- Prohibited relationships
- Communications between the audit committee and the independent auditor
- Change of independent auditors
- Addressing independence issues
- Guidance on consulting with the Office of the Chief Accountant

.33 More information on the topic of independence is available on the SEC Web site at www.sec.gov/about/offices/oca/ocaprof.htm.

SEC Small Business Initiatives

SEC Proposals Related to Small Businesses

.34 The SEC has issued six rule proposals related to small businesses' capital raising and disclosure requirements. Such proposals are trying to make reporting easier for small companies. The six most recently issued proposals are discussed in the following paragraphs.

.35 *Release No. 33-8812, "Revisions to the Eligibility Requirements for Primary Securities Offerings on Form S-3 and F-3."* The SEC is proposing to amend the eligibility requirements of Form S-3 and Form F-3 to allow domestic and foreign private issuers to conduct primary securities offerings on these forms without regard to the size of their public float or the rating of debt they are offering as long as they satisfy the other eligibility conditions of the respective form and do not sell more than the equivalent of 20 percent of their public float in primary offerings pursuant to the instructions on these forms over any period of 12 calendar months. More information can be found at www.sec.gov/rules/proposed/2007/33-8812.pdf.

.36 *Release Nos. 33-8819, 34-56013, and 39-2447, "Smaller Reporting Company Regulatory Relief and Simplification."* On July 5, 2007, the SEC proposed extending the benefits of the current optional disclosures and reporting requirements for smaller companies to a much larger group of companies. This proposal would allow companies with a public float of less than $75 million to qualify for smaller company requirements, up from $25 million for most companies today. The proposals also would combine for most purposes the small business issuer and nonaccelerated filer categories of smaller companies into a single category of smaller reporting companies. The full text of this release can be viewed at www.sec.gov/rules/proposed/2007/33-8819.pdf.

.37 *Release No. 33-8813, "Revisions to Rule 144 and Rule 145 to Shorten Holding Period for Affiliates and Non-Affiliates."* Under this release, the proposed holding period of six months would be extended for up to an additional six months, by the amount of time during which the security holder has engaged in hedging transactions. Restricted securities of companies that are not subject to the Securities Exchange Act of 1934 reporting requirements would continue to be subject to a one-year holding period prior to any public resale. They also propose to substantially reduce the restrictions on the resale of securities by nonaffiliates. This proposal will also simplify the Preliminary Note to Rule 144 in order to eliminate the manner of sale restrictions with respect to debt securities, increase Form 144 filing thresholds, and codify several staff interpretation positions that relate to Rule 144. In addition, the SEC proposes amendments to Securities Act Rule 145, which establishes resale limitations on certain persons who acquire securities in business combination transactions. The full text of this release can be found at www.sec.gov/rules/proposed/2007/33-8813.pdf.

.38 *Release No. 34-56010, "Exemption of Compensatory Employee Stock Options From Registration Under Section 12(g) of the Securities Exchange Act of 1934."* The SEC is proposing two exemptions from the registration requirements of the Securities Exchange Act of 1934 for compensatory employee stock options. The first exemption would be available to issuers that are not required to file periodic reports under the Securities Exchange Act of 1934. The proposed exemption would apply only to the issuer's compensatory employee stock options and would not extend to the class of securities underlying those options. The second exemption would be available to issuers that are required to file those reports because they have registered under Securities Exchange Act of 1934 Section 12 the class of securities underlying the compensatory employee stock options. The full text of this proposal can be found at www.sec.gov/rules/proposed/2007/34-56010.pdf.

.39 *Release No. 33-8828, "Revisions of Limited Offering Exemptions in Regulation D."* The SEC is proposing revision to Regulation D to provide additional flexibility to issuers and to clarify and improve the application of the rules. It proposes to create a new exemption from the registration provisions of the Securities Act of 1933 for offers and sales of securities to large accredited investors. The exemption would permit limited advertising in an exempt offering where each purchaser meets the definition of *large accredited investor*. They also propose revision to the term *accredited investor* in Regulation D to clarify the definition and reflect developments since its adoption. In addition, it proposes to shorten the timing required by the integration safe harbor in Regulation D and to apply uniform disqualification provisions to all offerings seeking to rely on Regulation D. It is soliciting comments on possible revisions to Rule 504 and on the definition of *accredited natural person* for certain pooled investment vehicles in Securities Act Rules 216 and 509 that it proposed in December 2006. The full text of this proposal can be found at www.sec.gov/rules/proposed/2007/33-8828.pdf.

.40 *Release Nos. 33-8814, 34-55980, and 39-2446, "Electronic Filing and Simplification of Form D."* The SEC has published for comment proposals that would mandate the electronic filing of information required by Securities Act of 1933 Form D. It is also proposing revisions to Form D and to Regulation D to simplify and restructure Form D and update and revise its information requirements. Additional information can be found at www.sec.gov/rules/proposed/2007/33-8814.pdf.

Other SEC Initiatives

IFRS "Roadmap"

.41 The SEC has outlined several initiatives concerning the proposed acceptance of foreign private issuers of financial statements prepared in accordance with IFRS without reconciliation to U.S. GAAP in the "Spotlight" section of its Web site. This section provides information regarding the SEC Roundtable on IFRS "Roadmap," SEC press releases on the issue, staff reviews of IFRS financial statements, and SEC speeches and public statements on the issue. This information can be accessed at www.sec.gov/spotlight/ifrsroadmap.htm.

Interactive Data and XBRL Initiatives

.42 On March 6, 2006, the SEC announced a series of roundtables to be conducted that will focus on speeding the implementation of new Internet tools that will help provide investors and analysts with better financial information about companies and funds. Interactive data permit Internet users to search for and use individual items of information from financial reports, such as net income and executive compensation. In July 2007, the SEC expanded the interactive data voluntary program to include mutual fund information. The most recent roundtable on this topic was held on March 19, 2007, in which they discussed using interactive data to create better disclosure documents and preparation of financial reports using interactive data, with a focus on mutual funds and public companies.

.43 On September 25, 2007, SEC Chairman Christopher Cox held a news conference regarding XBRL, where he announced the completion of all work on developing data tags for the entire system of U.S. GAAP. The project team has managed to map "every unique concept of U.S. GAAP to its own unique data tag," said Cox. He also remarked that a review for U.S. GAAP compliance by the Financial Accounting Foundation is nearing completion, and critical stakeholder groups including analysts, public company preparers, and software providers will be reviewing the draft taxonomies first, before a broad-based public view is initiated.

.44 If all goes according to plan, Cox said that the SEC staff would prepare recommendations on proposed rulemaking concerning XBRL and submit them to the SEC commissioners in the spring of 2008. Provided no major problems are uncovered, the SEC may be ready to adopt a final rule in the fall of 2008 that would mandate the use of XBRL in regulatory filings. For further information on interactive data and XBRL initiatives, as well as project updates, see www.sec.gov/spotlight/xbrl.htm.

SEC Advisory Committee

.45 In June 2006, the SEC established the Advisory Committee on Improvements to Financial Reporting. This committee held its first meeting on August 2, 2007. The SEC has appointed 17 members representing investors, companies, and various other entities within the securities markets. Five others will serve as official observers of the advisory committee, representing the FASB, Public Company Accounting Oversight Board (PCAOB), Department of the Treasury, IASB, and federal banking regulators. The advisory committee will examine the U.S. financial reporting system and provide recommendations about how to improve its usefulness for investors and reduce unnecessary complexity for U.S. companies. More specifically, the advisory committee will explore ways to redesign the financial reporting system to take advantage of interactive data and the XBRL computer language for financial reporting.

.46 The SEC's charter identifies the following more specific areas of inquiry for the advisory committee:

- The current approach to setting financial accounting and reporting standards, including (*a*) the principles-based versus rules-based standards; (*b*) the inclusion within standards of exceptions, bright lines, and safe harbors; and (*c*) the process for providing timely guidance on implementation issues and emerging issues
- The current process of regulating compliance with accounting and reporting standards
- The current system for delivering financial information to investors and accessing that information
- Other environmental factors that drive unnecessary complexity, including the possibility of being second-guessed, the structuring of transactions to achieve an accounting result, and whether there is hesitation by professionals to exercise professional judgment in the absence of detailed rules
- Whether there are current accounting and reporting standards that do not result in useful information to investors or impose costs that outweigh the resulting benefits

- Whether the growing use of international accounting standards has an impact on the relevant issues relating to complexity of U.S. accounting and reporting standards and the usefulness of the U.S. financial reporting system

.47 Additional information on this advisory committee can be found at www.sec.gov/about/offices/oca/acifr.shtml.

PCAOB Developments

.48 The summaries that follow are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable rule or development. In addition, the information presented in this section does not encompass all of the recent issuances and activities of the PCAOB. See the PCAOB Web site at www.pcaob.org for complete information.

PCAOB Approved Rules and Standards

Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

.49 On May 24, 2007, the PCAOB adopted Auditing Standard No. 5 that supersedes its Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), and an independence rule relating to the auditor's provision of internal control-related nonaudit services. It also adopted certain amendments to its interim standards. The SEC approved the standard on July 25, 2007.

.50 The PCAOB has closely monitored the implementation of Auditing Standard No. 2, and came to two conclusions:

1. The audit of internal control over financial reporting has produced significant benefits related to corporate processes and controls.
2. These benefits have come at a significant, higher than anticipated cost, and at times, the effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

.51 The PCAOB adopted the new Auditing Standard No. 5 to replace Auditing Standard No. 2 with the primary objective of focusing the auditor on matters most important to internal control. Goals of this new standard are to eliminate unnecessary procedures, to simplify and shorten the standard by reducing detail and specificity, and to make the audit more scalable for smaller and less complex companies. Some examples of important differences between Auditing Standard No. 5 and Auditing Standard No. 2 follow:

- The new standard is less prescriptive, with fewer mandatory requirements and more reliance on auditor judgment.
- The new standard makes the audit scalable so it can change to fit the size and complexity of any company.
- The new standard directs the auditor to focus on what matters most and eliminates unnecessary procedures from the audit.
- The new standard includes a principles-based approach to determining when and to what extent the auditor can use the work of others.

.52 The adopted standard will do the following, among other things:

- Direct the auditor to the most important controls and emphasize the importance of risk assessment using a top-down approach.
- Emphasize fraud controls, with an emphasis on assessing fraud risk in the planning process and additional guidance on the types of controls that may address fraud risk.
- Identify management fraud as an area of higher risk, directing the auditor to focus more attention in this area.
- Recalibrate the walkthrough requirement.
- Permit consideration of knowledge obtained during prior audits.
- Revise the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness.
- Adopt communication requirements, which require, among other things, that the auditor consider and communicate any identified significant deficiencies to the audit committee.
- Direct the auditor to tailor the audit to reflect attributes of smaller and less complex companies.
- Remove the requirement to evaluate management's process, which the PCAOB believes could contribute to a checklist approach to compliance by the auditors.
- Provide auditors with further guidance regarding scoping decisions for multiple location audits.

.53 Auditing Standard No. 5 is effective for audits of internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002 for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted at any point after SEC approval, which occurred on July 25, 2007. Auditors who elect to comply with Auditing Standard No. 5 after July 25, 2007, but before its effective date must also comply, at the same time, with Rule 3525 and other PCAOB standards as amended by Auditing Standard No. 5. Auditors who elect to comply with Auditing Standard No. 5 before its effective date should use the definition of *material weakness* contained in Auditing Standard No. 5. See www.pcaob.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.5.aspx for the full release document.

.54 Upon approval of the new standard by the SEC on July 25, 2007, the PCAOB announced that it is undertaking several initiatives to support the successful implementation of the standard. These initiatives include working closely with the audit firms, early in their process, as they evaluate how the new standard will affect their firms' audits of internal control. Other initiatives include continued outreach to public companies and smaller audit firms regarding the new standard. See full text of the press release at www.pcaob.org/News_and_Events/News/2007/07-25.aspx.

Considering and Using the Work of Others

.55 At the time the PCAOB proposed Auditing Standard No. 5 for public comment, the PCAOB also proposed an auditing standard titled *Considering and Using the Work of Others*, which would have superseded AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*). However, after considering all comments, the PCAOB decided to retain AU section 322 for both the financial statement audit and audit of internal control over financial reporting and incorporate language into Auditing Standard No. 5 that establishes integration concepts rather than adopting the proposed standard. Some of the key concepts in Auditing Standard No. 5 as they relate to using the work of others are as follows:

- Allows the auditor to use the work of others to obtain evidence about the design and operating effectiveness of controls for both the internal control audit and the financial statement audit, eliminating a barrier to integration of the two audits

- Eliminates the principal evidence provision
- Allows the auditor to use the work of company personnel other than internal auditors, as well as third parties working under the direction of management or the audit committee
- Requires the auditor to use a risk-based approach to the extent that the auditor can use the work of others

.56 For additional information, see paragraphs 16–19 of Auditing Standard No. 5 at www.pcaob.org/Rules/Rules_of_the_Board/Auditing_Standard_5.pdf.

Rule 3525, Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

.57 The PCAOB also adopted a new rule related to the auditor's responsibilities when seeking audit committee preapproval of internal control related nonaudit services. The rule is intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence. Specifically, the public accounting firm shall describe, in writing, the scope of the service and submit to the audit committee, as well as discuss with the audit committee, the potential effects of the service on the firm's independence. Registered firms are also required to document the substance of such discussions in writing. This rule is effective for audits of fiscal years ending on or after November 15, 2007 (the same effective date as Auditing Standard No. 5). The full text of this rule can be found at www.pcaob.org/Rules/Rules_of_the_Board/Rule_3525.pdf.

Conforming Amendments to Interim Auditing Standards

.58 In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments due to the issuance of Auditing Standard No. 5 can be found at www.pcaob.org/Rules/Rules_of_the_Board/Conforming_Amendments_AS5.pdf.

PCAOB Proposed Rules and Standards

Proposed Ethics and Independence Rule 3526, Communication with Audit Committees Concerning Independence *and Proposed Amendment to Rule 3523,* Tax Services for Persons in Financial Reporting Oversight Roles

.59 On July 24, 2007, the PCAOB proposed an ethics and independence rule, Rule 3526, that would supersede the PCAOB's interim independence requirement, Independence Standards Board (ISB) Standard No. 1, *Independence Discussions with Audit Committees*, and two related interpretations (ISB Interpretation 00-1 and ISB Interpretation 00-2). As part of the proposal, the PCAOB also proposed an amendment to Rule 3523 and further adjusted the implementation schedule for Rule 3523. See the "PCAOB Independence Initiatives" section of this alert (paragraphs .74–.79) for more information.

Proposed Auditing Standard Evaluating Consistency of Financial Statements and Proposed Amendments to Interim Auditing Standards

.60 On April 3, 2007, the PCAOB proposed changes to its auditing standards in light of the issuance of FASB Statement No. 154, *Accounting Changes and Error Corrections*, and the proposed FASB Statement *The Hierarchy of Generally Accepted Accounting Principles*. This proposal, if adopted and approved by the SEC, would do the following:

- Supersede AU section 420, *Consistency of Application of Generally Accepted Accounting Principles* (AICPA, *PCAOB Standards and Related Rules*), with a new auditing standard.

- Remove the U.S. GAAP hierarchy from the PCAOB's interim audit standards.
- Make conforming amendments to the PCAOB's interim auditing standards.

.61 For the full text of the proposal, see www.pcaob.org/Rules/Docket_023/2007-04-03_Release_No._2007-003.pdf.

PCAOB Standing Advisory Group

.62 The PCAOB Standing Advisory Group (SAG) is a 31-person panel representing the auditing profession, public companies, investors, and others charged with advising the PCAOB on the establishment of auditing and related professional practice standards. The SAG was established in April 2004 and meets approximately three times a year. Six organizations have been granted observer status at these meetings and include the:

- FASB
- Government Accountability Office (GAO)
- International Auditing and Assurance Standards Board
- SEC
- Department of Labor
- Auditing Standards Board of the AICPA

.63 The meetings can be heard via Webcast, and briefing papers can be accessed at www.pcaob.org/Standards/Standing_Advisory_Group/index.aspx.

June 2007 SAG Meeting

.64 On June 21, 2007, the SAG met to discuss auditing accounting estimates and fair value measurements, the PCAOB's interim standard on related parties, and engagement team performance. Additional details on each topic are noted in the following list:

- Accounting estimates, fair value measurements, and, more specifically, auditing procedures used for accounting estimates and fair value measurements were addressed. The SAG also discussed whether there is still a need for two separate PCAOB standards, one for accounting estimates and one for fair value measurements. The briefing paper from the meeting also discusses some of the similarities and differences in the auditing procedures required pursuant to the respective auditing standards.
- Engagement team performance was also a focus of the group, with the panel discussing whether more direction should be included in the PCAOB auditing and related professional practice standards about which members of the engagement team are responsible for performing the auditing procedures during an audit engagement. More specifically, they discussed the audit partner's involvement in the planning and supervision of the audit engagement and higher risk areas or areas that involve high risk and extensive use of professional judgment.
- A new project undertaken by the group is related parties, and a discussion of the interim auditing standard on related parties took place. The discussion focused mainly on the auditor's role in assessing risks relevant to related party transactions and performing sufficient audit procedures in identifying related parties and auditing transactions with those parties.

February 2007 SAG Meeting

.65 On February 22, 2007, the SAG met specifically to discuss proposed changes to Auditing Standard No. 2. In particular, they discussed the following:

- Whether the proposed standard for an audit of internal control allows for appropriate use of auditor judgment while sufficiently safeguarding the quality of the audit
- Whether the proposed standard for an audit of internal control adequately emphasizes the importance of company-level controls and the effect they may have on the auditor's testing
- Whether the direction in the standard on scaling the audit sufficiently addresses differences in company size and complexity
- Whether the standard would result in audit implementation issues

.66 In addition, the SAG discussed whether the proposed auditing standard on considering and using the work of others would meet the objective of removing unnecessary barriers to using the work of others and promote better integration of audits.

.67 The next SAG meeting will be held in October 2007, which will also be the PCAOB's annual meeting. Updated information related to this meeting, including an agenda, will be available at www.pcaob.org/Standards/Standing_Advisory_Group/index.aspx.

PCAOB Inspections

.68 Section 404 of Sarbanes-Oxley requires the PCAOB to conduct inspections of registered public accounting firms. In the inspections, the PCAOB assesses compliance with Sarbanes-Oxley, the rules of the PCAOB, and the rules of the SEC and professional standards in connection with the firm's performance of audits, issuance of audit reports, and related matters involving issuers. Sarbanes-Oxley requires the PCAOB to conduct those inspections annually for firms that provide audit reports for more than 100 issuers and at least triennially for firms that provide audit reports for fewer than 100 issuers. The PCAOB makes portions of the inspection reports public, and they can be accessed at www.pcaob.org/Inspections/Public_Reports/index.aspx.

.69 On May 24, 2007, the PCAOB held an open meeting and approved the PCAOB Inspection Frequency Rule. This rule eliminates the June 30, 2007, tentative sunset date for Rule 4003(d). Rule 4003(d) extends the time period during which the PCAOB must conduct the first and second inspections of firms that registered in 2003 and 2004. The PCAOB's action allows the rule to remain in place to provide ongoing, albeit limited, flexibility concerning the timing of the first two inspections of firms that registered in 2003 and 2004. That flexibility allows the PCAOB to make scheduling adjustments that will result in a mix of inspected firms (in terms of the size and nature of audit practices) that is relatively consistent from year to year, while avoiding significant year to year fluctuations in inspection resource requirements. The PCAOB has previously submitted Rule 4003(d) to the SEC for approval, and that submission is pending. In this meeting, the PCAOB also proposed for public comment an amendment to Rule 4003 that would remove the rule's requirement that the PCAOB regularly inspect certain firms that do not regularly issue audit reports, including firms that play a substantial role in audits but do not issue audit reports. Additional information regarding this meeting can be found at www.pcaob.org/news_and_events/news/2007/05-24.aspx.

Report on the Second Year Implementation of Auditing Standard No. 2

.70 On April 18, 2007, the PCAOB issued a report regarding issues identified in the implementation of Auditing Standard No. 2, which partly came about due to inspections that occurred during 2006. During 2006, the PCAOB reviewed portions of approximately 275 audits of internal control over financial reporting. These inspections revealed that progress was made in improving the efficiency of internal control audits. Many of these improvements resulted from the easing of time constraints that auditors and issuers faced in the first year, issuers' and auditors' additional experience, and changes that auditors made in their methodologies and staff training. However, the PCAOB also noted several areas where auditors can further improve their implementation of Auditing Standard No. 2. The PCAOB considered these areas of improvement when they introduced the new Auditing Standard No. 5. The full text of this release can be found at www.pcaob.org/Inspections/Other/2007/04-18_Release_2007-004.pdf.

PCAOB Accounting and Support Fee and Funding Process

.71 On April 18, 2007, the PCAOB staff published updated FAQs regarding the accounting support fee and funding process. The statements contained in these FAQs are not rules of the PCAOB, nor have they been approved by the PCAOB. The entire release can be accessed at www.pcaob.org/Support_Fees/SupportFeeFAQ.pdf.

.72 In May 2006, the PCAOB exposed for public comment rules for annual and special reporting of information in *Proposed Rules on Periodic Reporting by Registered Public Accounting Firms.* Under the proposed rules, all registered firms would be required to file an annual report with the PCAOB on Form 2. According to the proposed rules, the annual reports on Form 2 would be due on July 31st of each year. Recently, the PCAOB has clarified that because the rules have not yet been finalized, the first annual reports and annual fees will not be due by the June 30, 2007, and July 31, 2007, dates. The PCAOB stated that when it adopts final rules, it will set deadlines with reasonably sufficient lead time to allow firms to be able to comply. The PCAOB's statement on this matter can be found at www.pcaob.org/rules/docket_019/asr.pdf.

.73 On December 4, 2006, the SEC approved the PCAOB's 2007 annual budget and accounting fee. For more information, visit www.pcaob.org/news_and_events/news/2006/11-30.aspx. In addition, the PCAOB also posted its 2006 Annual Report, *Strengthening Investor Confidence*, to its Web site. A copy of the report can be found at www.pcaob.org/about_the_pcaob/annual_reports/2006.pdf.

PCAOB Independence Initiatives

Proposed Ethics and Independence Rule 3526 and Proposed Amendment to Rule 3523

.74 Proposed Rule 3526 would require a registered public accounting firm to communicate to an issuer's audit committee about any relationships between the firm and the issuer that may reasonably be thought to bear on the firm's independence. These communications would be required both before the firm accepts a new engagement pursuant to the standards of the PCAOB and at least annually for continuing engagements.

.75 As part of the same proposal, the PCAOB also proposed an amendment to Rule 3523 and further adjusted the implementation schedule for Rule 3523 as it applies to tax services provided during the audit period. Specifically, Rule 3523 will not apply to tax services provided on or before April 30, 2008, when those services are provided during the audit period and are completed before the professional engagement period begins. In addition, if the PCAOB does amend Rule 3523 as described, registered firms would remain responsible for considering the relevant facts and circumstances of a specific tax engagement and determining whether their independence is impaired under the SEC's general standard of independence.

.76 Lastly, the PCAOB also proposed to add a note to Rule 3523 with respect to an initial public offering (IPO). The note would state that in the context of an IPO, the provision of tax services to a person covered by Rule 3523 before the date that the firm either (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB or (2) began procedures to do so (whichever date is earlier) does not impair a registered public accounting firm's independence under Rule 3523. Comments on this proposal were due back by September 7, 2007.

.77 The full text of the release can be found at www.pcaob.org/Rules/Docket_017/2007-07-24_Release_2007-008.pdf.

Staff Questions and Answers on Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees

.78 On April 3, 2007, the PCAOB issued staff questions and answers on ethics and independence rules as they relate to tax services and contingent fees. Topics covered include the following:

- The application of Rule 3522(a) when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm
- Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction
- Whether a registered public accounting firm's independence is affected by the IRS's subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b)
- Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself
- Clarification of the term *other change in employment event* as it relates to Rule 3522(c)

.79 The full text of the staff questions and answers can be found at www.pcaob.org/Standards/Staff_Questions_and_Answers/2007/Tax_Services.pdf.

PCAOB Small Business Initiatives

Forum on Auditing in the Small Business Environment

.80 The series of forums on Auditing in the Small Business Environment is a program for registered accounting firms and public companies in the small business community to learn more about the work of the PCAOB. The PCAOB began holding small business forums in 2004. To date, the forums have enabled board members and staff to meet with more than 1,600 representatives of small registered public accounting firms and small public companies to provide insight to the work of the PCAOB, particularly the inspections process and impact of the new auditing standards. The next forum will be held on October 22nd and 23rd in New York, NY. For more information regarding the small business forums, readers can access www.pcaob.org/News_and_Events/News/2007/01-03a.aspx.

Recent Speeches From the PCAOB Regarding Small Business Issues

.81 PCAOB Chairman Olson testified before the Committee on Small Business on June 5, 2007, regarding small business initiatives. Mr. Olson focused his remarks on the PCAOB's oversight and interaction with small firms. He described various PCAOB activities and initiatives, including the following:

- Outreach efforts involving discussion sessions that are designed to assist small registered firms become better equipped with information to address the challenges of the regulatory environment
- The PCAOB's supervisory inspection program that helps small firms focus on audit quality necessary to compete in the market to provide public company audit services
- The PCAOB standard setting activities that are performed with the needs and challenges of smaller firms in mind

.82 With respect to smaller firm activity in the SEC audit marketplace, he noted that smaller CPA firms are gaining ground in the market for SEC audits. He noted that while the Big Four firms have reduced their public company audit client bases by more than 1,000 clients since 2002, he said that "the next 4 and even smaller firms have increased the number of public companies that they audit: the next 4 have added more than 250 audit clients among them, and smaller firms have taken on more than 580 audit clients." Mr. Olson expressed confidence that smaller firms will continue to seize opportunities to grow in the marketplace. You can find further information regarding this testimony at www.pcaobus.org/news_and_events/events/2007/testimony/06-05_olson.aspx.

Other PCAOB Initiatives

Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud

.83 On January 22, 2007, the PCAOB issued a report that addresses the auditors' responsibility as it relates to fraud, principally as it relates to AU Section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*). Major topics discussed include the following:

- Auditors' overall approach to the detection of fraud
- Brainstorming sessions and fraud-related inquiries
- Auditors' response to fraud risk factors
- Financial statement misstatements
- Risk of management override of controls
- Other areas to improve fraud detection

.84 The full report can be accessed at www.pcaob.org/Inspections/Other/2007/01-22_Release_2007-001.pdf.

Other Related Developments and Resources

Committee for Sponsoring Organizations of the Treadway Commission Developments

.85 On January 8, 2007, the Committee for Sponsoring Organizations of the Treadway Commission (COSO) announced the selection of Grant Thornton LLP to develop guidance designed to help organizations monitor the quality of their internal control systems. The end product will serve as a tool for effectively monitoring internal controls and complying with the Sarbanes-Oxley Act of 2002.

.86 On September 17, 2007, COSO released for public comment a Discussion Document titled "Guidance on Monitoring Internal Control Systems." The second phase of the monitoring project, scheduled for release after comments are received on this Discussion Document, will provide examples, case studies, and tools to assist all organizations in implementing effective and efficient monitoring. Then COSO plans to release an exposure draft of the full implementation guidance later this year and to release the final guidance in the first quarter of 2008.

.87 In addition to the COSO project team, COSO has assembled an oversight task force consisting of representatives from its five sponsoring organizations as well as other experts. It will also have observers from the SEC, PCAOB, the U.S. GAO, and representatives from Europe, as well as both small and large companies. Updates on COSO's monitoring project will be posted to www.coso.org as available.

Resource Central

.88 The following are various resources that practitioners may find beneficial.

Publications

.89 Practitioners may find the following publications useful with respect to accounting and auditing of public companies:

- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- Audit Risk Alert *Independence and Ethics—2007/08* (product no. 022478kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment*(product no. 022526kk)
- AICPA *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)
- *PCAOB Standards and Related Rules* (product no. 057207kk)

AICPA reSOURCE: Accounting and Auditing Literature

.90 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, TPAs, 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.

Continuing Professional Education

.91 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191 [DVD]). 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.
- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

.92 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.93 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 for nonmembers) for a new subscription and $119 ($369 for nonmembers) for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some courses currently available related to SEC and PCAOB developments follow:

- *SEC Reporting* (product no. 736774)
- *Annual Public Company Update: SEC, PCAOB, and Other Developments* (product no. 731883)
- *PCAOB Standards and Related Rules* (product no. 057207 [text] or WPC-BX [online subscription])
- *SEC Quarterly Update Webcast Series* (product no. SEC-XX)

.94 To register or learn more, visit www.cpa2biz.com.

Webcasts

.95 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.96 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of *hot topics* that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.97 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is *hot* at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you *plugged in* to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.98 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.99 Do you have a complex technical question about U.S. GAAP, other comprehensive bases of accounting, 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 the answer. You can reach the Technical Hotline at (888) 777-7077.

Ethics Hotline

.100 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.

Annual Conference

.101 The AICPA sponsors an annual National Conference on Current SEC and PCAOB Developments in December each year. The National Conference on Current SEC and PCAOB Developments is a three-day conference designed to provide comprehensive SEC and PCAOB updates directly from the regulators. For more information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

SEC Research

.102 The SEC has posted two useful guides to its Web site. The first guide provides an overview of how to research the federal securities laws through the SEC Web site and has been provided by the SEC as a service to investors and members of the public. This guide can be accessed at www.sec.gov/investor/pubs/securitieslaws.htm. The second guide provides information on how to research public companies through EDGAR on the SEC Web site by providing tips and answers to FAQs. EDGAR provides free public access to corporate information and SEC filings. The guide states that to use EDGAR effectively, you should know which categories of information appear in which SEC filings and which search methods would work best. In addition, you should also understand the limitations of EDGAR. The guide will help you achieve this. This guide can be accessed at www.sec.gov/investor/pubs/edgarguide.htm.

Center for Audit Quality

.103 The Center for Audit Quality (CAQ) (formerly the Center for Public Company Audit Firms) was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.104 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit www.thecaq.org or the members-only site at http://thecaq.aicpa.org.

SEC Regulations Committee

.105 The SEC Regulations Committee meets periodically with the staff of the SEC to discuss emerging technical accounting and reporting issues relating to SEC rules and regulations. The mission of the SEC Regulations Committee is to protect investors by improving the quality of public-company financial reporting by identifying, discussing, and facilitating resolution of issues relating to the promulgation, interpretation, and application of SEC rules, regulations, and policies with the assistance of SEC staff and communicating those matters publicly on a timely basis. To view highlights of issues discussed at the SEC Regulations Committee joint meetings with SEC staff, go to the CAQ Web page at http://thecaq.aicpa.org/Resources/SEC+Regulations+Committee/SEC+Regulations+Committee+Highlights.htm.

.106 The International Practices Task Force (IPTF) is a task force of the SEC Regulations Committee. IPTF also meets periodically with the staff of the SEC to discuss and focus on international emerging technical accounting and reporting issues relating to SEC rules and regulations. The mission of the IPTF is to protect investors by improving the quality of public-company financial reporting by identifying, discussing, and facilitating resolution of issues relating to the promulgation, interpretation, and application of SEC rules, regulations, and policies with the assistance of the SEC staff and communicating those matters publicly on a timely basis. You can visit the IPTF Web page at http://thecaq.aicpa.org/Resources/International+Practices+Task+Force/ for more information.

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.107 This Audit Risk Alert replaces the *SEC and PCAOB Alert—2006/07*.

.108 The *SEC and PCAOB Alert* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to killuzzi@aicpa.org or write to:

Kristy L. Illuzzi, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

[*The next page is 9000-211*.]

AAM Section 8290

Understanding the New Auditing Standards Related to Risk Assessment

NOTICE TO READERS
UNDERSTANDING THE NEW AUDITING STANDARDS RELATED TO RISK ASSESSMENT

This Audit Risk Alert is intended to provide auditors with an overview of the new risk assessment standards to be used in the planning and performance of a financial statement audit.

This publication is an *Other Auditing Publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

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.

Written by Michael J. Ramos, CPA

Edited by Lori L. Pombo, CPA
Technical Manager
Accounting and Auditing Publications

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Introduction

.01 This audit Alert provides a summary of eight Statements on Auditing Standards (SASs) that provide extensive guidance on how you should apply the audit risk model in the planning and performance of a financial statement audit. These SASs were issued in March 2006 and become effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted. While the time period between the issuance and effective date of the standards may seem long, you should not underestimate the standards' significance and the far-reaching effect they will have on your audits.

.02 The eight SASs[1] consist of:

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[1] Statements on Auditing Standards issued by the Auditing Standard Board are applicable to audits of privately held entities and other *nonissuers*. The term *issuer* means entities that are subject to the rules and regulations of the U.S. Securities and Exchange Commission and the Sarbanes-Oxley Act of 2002.

- SAS No. 104, *Amendment to Statement on Auditing Standards No. 1*, Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*
- SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards
- SAS No. 106, *Audit Evidence*
- SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*
- SAS No. 108, *Planning and Supervision*
- SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling

.03 The Auditing Standards Board (ASB) believes that the SASs represent a significant strengthening of auditing standards that will improve the quality and effectiveness of audits. The primary objective of the SASs is to enhance your application of the audit risk model in practice by requiring, among other things:

- A more in-depth understanding of your audit client and its environment, including its internal control. This knowledge will be used to identify the risk of material misstatement in the financial statements (whether caused by error or fraud) and what the client is doing to mitigate them.
- A more rigorous assessment of the risk 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.

.04 The development of these SASs was undertaken in response to recommendations to the ASB made by the former Public Oversight Board's Panel on Audit Effectiveness. In addition, the major corporate failures of the past several years have undermined the public's confidence in the effectiveness of audits and led to an intense scrutiny of the work of auditors, and the development of the SASs also have been influenced by these events.

How the Risk Assessment Standards Affect Current Practice

.05 The SASs incorporate many of the underlying concepts and detailed performance requirements that exist in the current standards. However, the SASs do create significant new requirements for auditors.

.06 In most cases, implementation of the SASs will result in an overall increased work effort by the audit team. It also is anticipated that, to implement the SASs appropriately, many firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. To ease the implementation process, it is recommended that firms adopt at least some of the provisions of the standards in advance of the required implementation date.

How This Alert Is Organized

.07 This Alert is organized into three different parts.

- *Part One: Key Provisions of the SASs and How They Differ From Current Standards*. This part provides a summary of some of the key provisions of the SASs and how they differ, if at all, from current audit standards.

- *Part Two: Fundamental Concepts*. This part summarizes the guidance in the SASs relating to fundamental audit concepts such as materiality, financial statement assertions, and audit evidence.
- *Part Three: Applying the Audit Risk Model*. This part of the Alert provides a summary of the application of the audit risk model as described by the SASs.

Part One: Key Provisions of the SASs and How They Differ From Current Standards

.08 This section discusses the key provisions of each of the SASs and provides a summary of how each of the SASs differs, if at all, from the current AICPA generally accepted audit standards.

SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*

.09

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 104 defines *reasonable assurance* as a "high level of assurance."	• SAS No. 104 clarifies the meaning of reasonable assurance.

SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards

.10

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 105 expands the scope of the understanding that the auditor must obtain in the second standard of field work from "internal control" to "the entity and its environment, including its internal control." • The quality and depth of the understanding to be obtained is emphasized by amending its purpose from "planning the audit" to "assessing the risk of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures."	• Previous guidance considered the understanding of the entity to be a part of audit planning, and emphasized that the understanding of internal control also was primarily part of audit planning. • By stating that the purpose of your understanding of the entity and its internal control is part of assessing the risk of material misstatement, SAS No. 105 essentially considers this understanding to provide audit evidence that ultimately supports your opinion on the financial statements. • The new standard emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures. It is anticipated that "generic" audit programs will not be an appropriate response for all engagements because risks vary between entities.

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Key Provisions	How the SAS Differs From Current Standards
	• The term *further audit procedures*, which consists of test of controls and substantive tests, replaces the term *tests to be performed* in recognition that risk assessment procedures are also performed. • The term *audit evidence* replaces the term *evidential matter.*

SAS No. 106, *Audit Evidence*

.11

Key Provisions	How the SAS Differs From Current Standards
• SAS No. 106 defines *audit evidence* as "all the information used by the auditor in arriving at the conclusions on which the audit opinion is based."	• Previous guidance did not define audit evidence. • SAS No. 106 also describes basic concepts of audit evidence. • The term *sufficient, appropriate audit evidence,* defined in SAS No. 106, replaces the term *sufficient, competent evidence.*
• SAS No. 106 recategorizes assertions by classes of transactions, account balances, and presentation and disclosure; expands the guidance related to presentation and disclosure; and describes how the auditor uses relevant assertions to assess risk and design audit procedures.	• SAS No. 106 recategorizes assertions to add clarity. • *Assertion relating to presentation and disclosure* has been expanded and includes a new assertion that information in disclosures should be "expressed clearly" (understandability).
• SAS No. 106 defines *relevant* assertions as those assertions that have a meaningful bearing on whether the account is fairly stated.	• The term *relevant assertions* is new, and it is used repeatedly throughout SAS No. 106.
• SAS No. 106 provides additional guidance on the reliability of various kinds of audit evidence.	• The previous standard included a discussion of the competence of evidential matter and how different types of audit evidence may provide more or less valid evidence. SAS No. 106 expands on this guidance.
• SAS No. 106 identifies "risk assessment procedures" as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement at the financial statement and relevant assertion levels.	• SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risk of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately supports the auditor's opinion on the financial statements.
• SAS No. 106 provides that evidence obtained by performing risk assessment procedures, as well as that obtained by performing tests of controls and substantive procedures, is part of the	

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Key Provisions	*How the SAS Differs From Current Standards*
evidence the auditor obtains to draw reasonable conclusions on which to base the audit opinion, although such evidence is not sufficient in and of itself to support the audit opinion.	
• SAS No. 106 describes the types of audit procedures that the auditor may use alone or in combination as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor.	• Risk assessment procedures include: — Inquiries of management and others within the entity — Analytical procedures — Observation and inspection
• SAS No. 106 includes guidance on the uses and limitations of inquiry as an audit procedure.	• Inquiry alone is not sufficient to evaluate the design of internal control and to determine whether it has been implemented.

SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*

.12

Key Provisions	*How the SAS Differs From Current Standards*
• The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of: 1. Determining the extent and nature of risk assessment procedures. 2. Identifying and assessing the risk of material misstatement. 3. Determining the nature, timing, and extent of further audit procedures. 4. Evaluating whether the financial statements taken as a whole are presented fairly, in conformity with generally accepted accounting principles.	• Previous guidance said that auditors "should consider" audit risk and materiality for certain specified purposes. SASs state that the auditor "must" consider. • New guidance explicitly states that audit risk and materiality are used to identify and assess the risk of material misstatement.
• Combined assessment of inherent and control *risks* is termed the *risk of material misstatement*.	• SAS No. 107 consistently uses the term *risks of material misstatement*, which often is described as a combined assessment of inherent and control risk. However, auditors may make separate assessment of inherent risk and control risks.
• The auditor should assess the risk of material misstatement as a basis for further audit procedures. Although that risk assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment.	• SAS No. 107 states that the auditor should have and document an appropriate basis for the audit approach. • These two provisions of the risk assessment standards effectively eliminate the ability of the auditor to assess control risk "at the maximum"

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Key Provisions	*How the SAS Differs From Current Standards*
• Assessed risks and the basis for those assessments should be documented.	without having a basis for that assessment. In other words, you can no longer "default" to maximum control risk.
• The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management.	• SAS No. 107 provides additional guidance on communicating misstatements to management. • The concept of not accumulating misstatements below a certain threshold is included in the previous standards, but the SAS No. 107 provides additional specific guidance on how to determine this threshold.
• The auditor should request management to respond appropriately when misstatements (known or likely) are identified during the audit.	• SAS No. 107 provides specific guidance regarding the appropriate auditor's responses to the types of misstatements (known or likely) identified by the auditor.

SAS No. 108, *Planning and Supervision*

.13

Key Provisions	*How the SAS Differs From Current Standards*
SAS No. 108 provides guidance on: • Appointment of the independent auditor. • Establishing an understanding with the client. • Preliminary engagement activities. • The overall audit strategy. • The audit plan. • Determining the extent of involvement of professionals possessing specialized skills. • Using a professional possessing information technology (IT) skills to understand the effect of IT on the audit. • Additional considerations in initial audit engagements. • Supervision of assistants.	• Much of the guidance provided in SAS No. 108 has been consolidated from several existing standards. • However, SAS No. 108 provides new guidance on preliminary engagement activities, including the development of an overall audit strategy and an audit plan. — The overall audit strategy is what previously was commonly referred to as the audit approach. It is a broad approach to how the audit will be conducted, considering factors such as the scope of the engagement, deadlines for performing the audit and issuing the report, and recent financial reporting developments. — The audit plan is more detailed than the audit strategy and is commonly referred to as the audit program. The audit plan describes in detail the nature, timing, and extent of risk assessment and further audit procedures you perform in an audit. • SAS No. 108 states that you should obtain a written understanding with your client.

SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

.14

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 109 describes audit procedures that the auditor should perform to obtain the understanding of the entity and its environment, including its internal control.	• The auditor should perform "risk assessment procedures" to gather information and gain an understanding of the entity and its environment. These procedures include inquiries, observation, inspection, and analytical procedures. Previous standards did not describe the procedures that should be performed to gain an understanding of the client. • Information about the entity may be provided by a variety of sources, including knowledge about the entity gathered in previous audits (provided certain conditions are met), and the results of client acceptance and continuance procedures. • SAS No. 109 also directs the auditor to perform a variety of risk assessment procedures, and it describes the limitations of inquiry.
• The audit team should discuss the susceptibility of the entity's financial statements to material misstatement.	• Previous standards did not require a "brainstorming" session to discuss the risk of material misstatements. SAS No. 109 requires such a brainstorming session, which is similar (and may be performed together with) the brainstorming session to discuss fraud.
• The purpose of obtaining an understanding of the entity and its environment, including its internal control, is to identify and assess "the risk of material misstatement" and design and perform further audit procedures responsive to the assessed risk.	• SAS No. 109 directly links the understanding of the entity and its internal control with the assessment of risk and design of further audit procedures. Thus, the understanding of the entity and its environment, including its internal control, provides the audit evidence necessary to support the auditor's assessment of risk.
• SAS No. 109 states the auditor should assess the risk of material misstatement at both the financial statement and relevant assertion levels.	• The previous standard included the concept of assessing risk at the financial statement level, but SAS No. 109 provides expanded and more explicit guidance. • SAS No. 109 also directs the auditor to determine how risks at the financial statement level may result in risks at the assertion level.
• SAS No. 109 provides directions on how to evaluate the design of the entity's controls and determine whether the controls are adequate and have been implemented.	• Under the previous standard, the primary purpose of gaining an understanding of internal control was to plan the audit. Under SAS No. 109, your understanding of internal control is used to assess risks. Thus, the

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Key Provisions	*How the SAS Differs From Current Standards*
	understanding of internal control provides audit evidence that ultimately supports the auditor's opinion on the financial statements. • The previous standard directs the auditor to obtain an understanding of internal control as part of obtaining an understanding of the entity and its environment. SAS No. 109 requires auditors to evaluate the design of controls and determine whether they been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. It is anticipated that this phase of the audit will require more work than simply gaining understanding of internal control.
• SAS No. 109 directs the auditor to consider whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.	• Previous standard did not include the concept of "significant risks." • Significant risks exist on most engagements. • The auditor should gain an understanding of internal control and also perform substantive procedures for all identified significant risks. Substantive analytical procedures alone are not sufficient to test significant risks.
• SAS No. 109 provides extensive guidance on the matters that should be documented.	• The guidance provided by SAS No. 109 relating to documentation is significantly greater than that provided by previous standards. • Part three of this Alert lists the documentation requirements of the SASs.

SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*

.15

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 110 provides guidance on determining overall responses to address the risk of material misstatement at the financial statement level and the nature of those responses.	• The concept of addressing the risk of material misstatement at the financial statement level and developing an appropriate overall response is similar to the requirement in previous standards relating to the consideration of audit risk at the financial statement level. However, that guidance was placed in the context of audit planning. SAS No. 110 "repositions" your consideration of risk at the financial statement level so you make this assessment as a result of and in

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Key Provisions	*How the SAS Differs From Current Standards*
	conjunction with your performance of risk assessment procedures. In some cases, this assessment may not be able to be made during audit planning. • SAS No. 110 requires you to consider how your assessment of risks at the financial statement level affect individual financial statement assertions, so that you may design and perform tailored further audit procedures (substantive tests or tests of controls). • The list of possible overall responses to the risk of material misstatement at the financial statement level also has been expanded.
• Further audit procedures, which may include tests of controls, or substantive procedures should be responsive to the assessed risk of material misstatement at the relevant assertion level.	• Although the previous standards included the concept that audit procedures should be responsive to assessed risks, this idea was embedded in the discussion of the audit risk model. The SASs repeatedly emphasize the need to provide a clear linkage between your understanding of the entity, your risk assessments, and the design of further audit procedures. • SAS No. 110 requires you to document the linkage between assessed risks and further audit procedures, which was not a requirement under the previous standards.
• SAS No. 110 provides guidance on matters the auditor should consider in determining the nature, timing, and extent of such audit procedures.	• The new guidance on determining the nature, timing, and extent of tests of controls and substantive tests has been expanded greatly and addresses issues that previously were not included in the authoritative literature. • SAS No. 110 states that the nature of further audit procedures is of most importance in responding to your assessed risk of material misstatement. That is, increasing the extent of your audit procedures will not compensate for procedures that do not address the specifically identified risks of misstatement. • SAS No. 110 states that you should perform certain substantive procedures on all engagements. These procedures include: — Performing substantive tests for all relevant assertion related to each material class of transactions, account balance, and disclosure regardless of the assessment of the risk of material misstatements.

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Key Provisions	How the SAS Differs From Current Standards
	— Agreeing the financial statements, including their accompanying notes, to the underlying accounting records — Examining material journal entries and other adjustments made during the course of preparing the financial statements

SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

.16

Key Provisions	How the SAS Differs from Current Standards
• SAS No. 111 provides guidance relating to the auditor's judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls.	• SAS No. 111 provides enhanced guidance on tolerable misstatement. In general, tolerable misstatement in an account should be less than materiality to allow for aggregation in final assessment.

Part Two: Fundamental Concepts

.17 The SASs describe a process for applying the audit risk model to gather audit evidence and form an opinion about your client's financial statements. To apply this process appropriately, you will need to have a working knowledge of the key concepts upon which it is built. Those concepts include the following.

- The meaning of *reasonable assurance*
- Audit risk and the risk of material misstatement
- Materiality and tolerable misstatement
- Financial statement assertions
- Internal control
- Information technology
- Audit evidence

.18 This part of the Alert provides a summary of these key concepts and a description of how they are used.

Reasonable Assurance

.19 The auditing standards make numerous references to your responsibility for obtaining "reasonable assurance." For example, your audit opinion states that generally accepted auditing standards require you to "obtain reasonable assurance about whether the financial statements are free of material misstatement." "Reasonable assurance" is the fundamental threshold you use to design and perform your audit procedures. For this reason, it is important that you have a working knowledge of the term.

.20 SAS No. 104 clarifies that reasonable assurance is a high, but not absolute, level of assurance. Put another way, you must plan and perform your audit in such a way to obtain sufficient appropriate audit evidence to reduce audit risk to a low level. Although "reasonable assurance" is a high level of assurance, it is not absolute assurance. Absolute level of assurance is not attainable because an auditor does not examine 100 percent of the entity's transactions or events and because of the limitations of the entity's internal control.

Audit Risk and the Risk of Material Misstatement

.21 Audit risk (AR) is the risk that the financial statements are materially misstated and you fail to detect such a misstatement or appropriately modify your opinion. You should perform your audit to reduce audit risk to a low level. You need to consider audit risk at all stages of your audit.

.22 Audit risk is a function of two components:

1. *Risk of material misstatement (RMM)*, which is the risk that an account or disclosure item contains a material misstatement. The risk of material misstatement is a combination of inherent and control risk.

2. *Detection risk*, which is the risk that you will not detect such misstatements in an account or disclosure item.

.23 Reducing audit risk to a low level requires you to:

1. Assess the risk of material misstatement.

2. Based on that assessment, design and perform further audit procedures to reduce audit risk to an appropriate low level.

Assessing the Risk of Material Misstatement

.24 The risk of material misstatement exists independently of detection risk. Many factors affect the risk of material misstatement, including the following.

- The client's industry, its regulatory environment, and other external factors
- The nature of the entity, for example, its operations, ownership, and financing
- The client's objectives, strategies, and related business risks
- How client management measures and reviews the company's financial performance
- The client's internal control, which includes the selection and application of accounting policies

Thus, the first step in assessing the risk of material misstatement is to gather information and gain an understanding of these and other items that create risks. Part Three of this Alert describes an audit process that begins with your gaining an understanding of these matters.

.25 The risk of material misstatement may reside at either the financial statement level or the assertion level.

- *Financial statement-level risks* potentially affect many different assertions. For example, a lack of qualified personnel in financial reporting roles (an element of the client's control environment) may affect many different accounts and several assertions.

- *Assertion-level risks* are limited to a single assertion, for example, the valuation of inventory or the occurrence of sales.

.26 Your response to assessed risks will differ depending on whether they reside at the financial statement or assertion level.

- Financial statement-level risks typically require an overall response, such as providing more supervision to the engagement team or incorporating additional elements of unpredictability in the selection of your audit procedures.
- Assertion-level risks are addressed by the nature, timing, and extent of further audit procedures.

For this reason, you should assess the risk of material misstatement at both the financial statement and the assertion level.

.27 Your assessment of the risk of material misstatement (at both the financial statement and the assertion level) should be directly linked to the design and performance of further audit procedures. For example, if your understanding of the client, its environment, and its internal control lead you to assess that there is a high inherent risk that inventory quantities could be misstated, you would design tailored further audit procedures to specifically respond to that risk.

.28 To perform audit procedures that are appropriately responsive to your assessed risks, you should define these risks in a way that incorporates the unique circumstances at the client. Generic checklists and standard audit programs may serve as a starting point for helping you to understand and assess risk, but to be truly effective, these generic audit tools need to be tailored to the specific circumstances of your client.

.29 The process for applying the audit risk model, which is summarized in Part Three of this Alert, describes in more detail how you should link your assessment of risk to the design and performance of further audit procedures.

.30 ***Risks of Material Misstatement at the Assertion Level.*** At the assertion level, the risk of material misstatement consists of two components:

- *Inherent risk (IR),* which is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls. Inherent risk is greater for some assertions and related account balances, classes of transactions, and disclosures than for others.
- *Control risk (CR)*, which 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 client's internal control. Control risk is a function of the effectiveness of the design and operation of the client's internal control.

Detection Risk

.31 Detection risk is the risk that you will not detect a material misstatement that exists in an assertion. It is a function of the nature, timing, and effectiveness of audit procedures and how you apply them.

.32 Detection risk relates to your substantive audit procedures and is managed by how you respond to the risk of material misstatement at both the financial statement and the assertion level.

- *Financial statement-level risks.* Your responses to financial statement-level risks may include assignment of more experienced personnel to the engagement team, emphasizing of the application of professional skepticism, and providing more supervision and review of the audit work performed. Appropriate choices related to these matters will help you mitigate the risks that you might select an inappropriate audit procedure, misapply audit procedures, or misinterpret the results.
- *Assertion-level risks.* In response to assertion-level risks you will determine the nature, timing, and extent of your further audit procedures that are appropriate to respond to the assessed risk.

Thus, the effectiveness of further audit procedures depends on whether you have:

1. Acquired a sufficient depth and breadth of understanding of your client to make an informed assessment of the risk of material misstatements.

2. Used your assessment of the risks of material misstatement to drive the nature, timing, and extent of your further audit procedures.

.33 ***An Inverse Relationship Between the Risk of Material Misstatement and Detection Risk.*** At the assertion level, detection risk has an inverse relationship to the risk of material misstatement. The greater the risk of material misstatement, the less the detection risk that you should be willing to accept. Put another way, the greater the risk of material misstatement, the more reliable your substantive tests should be.

.34 Conversely, when the risk of material misstatement is low, you can accept a greater level of detection risk. However, you are always required to perform substantive tests on all relevant assertions related to each material account balance, class of transactions, and disclosure, regardless of your assessment of the risk of material misstatement.

.35 The model AR = RMM x DR expresses the general relationship of audit risk and its components. You may find this model useful when planning appropriate risk levels for your audit procedures, keeping in mind your overall desire to reduce audit risk to an appropriate low level.

Materiality and Tolerable Misstatement

The Concept of Materiality

.36 The concept of materiality recognizes that some matters are more important for the fair presentation of the financial statements than are others. In performing your audit, you are concerned with matters that could be material to the financial statements. Your responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by error or fraud, are detected.

.37 Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, defines *materiality* as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed by the omission or misstatement." Thus, materiality is influenced by your perception of the needs of financial statement users who will rely on the financial statements to make judgments about your client's financial position and results of operations.

How Materiality Is Used in Your Audit

.38 Though defined by the accounting literature, materiality also is an audit concept of critical importance. Audit materiality represents the maximum amount that you believe the financial statements could be misstated and still fairly present the client's financial position and results of operations. Audit materiality affects:

1. *The nature, timing, and extent of audit procedures.* During audit planning, you should determine a materiality level for the financial statements taken as a whole. This initial determination of materiality will help you:

   — Make judgments when identifying and assessing the risk of material misstatement

   — Determine the nature, timing, and extent of your further audit procedures

2. *The evaluation of audit findings.* To form an opinion about the financial statements, you must evaluate audit findings and determine whether the misstatements that are not corrected by the client, individually or in the aggregate, are material to the financial statements.

Quantitative and Qualitative Considerations

.39 Although materiality commonly is expressed in quantitative terms, your determination of materiality is a matter of professional judgment that includes both quantitative and qualitative considerations. During the course of your audit, you should be alert for misstatements that could be qualitatively material. However, it ordinarily is not practical to design audit procedures to detect misstatements that qualitatively are material, and for that reason, materiality used for planning purposes considers primarily quantitative matters.

Tolerable Misstatement

.40 During audit planning you must determine an initial level of materiality for the purposes of designing and performing your audit procedures. This initial determination of materiality is determined for the financial statements taken as a whole. However, in designing your audit procedures, you should take into account the possibility that several misstatements of amounts less than financial statement materiality could—in the aggregate—result in a material misstatement of the financial statements. That is, errors in an account or disclosure may still exist and your audit procedures may fail to detect them. For that reason, you need to allow for these undetected misstatements that may exist. You build this allowance into the overall audit strategy process by setting tolerable misstatement.

.41 Tolerable misstatement (also referred to as tolerable error) is defined as the maximum error in a population (for example, the class of transactions or account balance) that you are willing to accept. Tolerable misstatement normally is lower than materiality for the financial statements as a whole. For each class of transactions, account balance, and disclosure, you should determine at least one level of tolerable misstatement.

.42 For example, if for planning purposes you determined materiality to be $100,000, you could set tolerable misstatement at $60,000. Then, you would use this tolerable misstatement level to determine the nature, timing, and extent of your further audit procedures. You could use different levels of tolerable misstatement for other account balances, classes of transactions, or assertions. See AU section 350, *Audit Sampling*, of volume 1 of the AICPA *Professional Standards* for more guidance about tolerable misstatement.

Financial Statement Assertions

Why Financial Statement Assertions Are Important

.43 Your audit results in an opinion of the financial statements taken as a whole. However, to reach this opinion of the financial statements, most of your audit procedures should be directed at a much more detailed level, the assertion level.

.44 Assertions are management's implicit or explicit representations regarding the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures. Assertions fall into three categories: (1) classes of transactions, (2) account balances, and (3) presentation and disclosure.

.45 For example, by presenting the information "Cash . . . .$XXX" in the financial statements, management implies that:

- The cash truly exists and company has the right to use it.
- The amount presented represents all the company's cash.
- The amount presented is accurate.

.46 Many of your audit procedures are performed not on the financial statements taken as a whole nor even at the account or disclosure level, but rather, they are directed at individual assertions.

.47 Relating identified risks of material misstatement to misstatements that might occur at the assertion level is necessary for you to properly link assessed risks to further audit procedures.

.48 The table titled "Categories of Assertions" provides a summary of how assertions might be grouped into various categories. You may express these assertions differently, as long as your descriptions encompass all the aspects described in the table.

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred and pertain to the entity.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described and information in disclosures is expressed clearly.

How You Use Assertions in Your Audit

.49 Most of your tests of controls and substantive audit procedures are directed at specific assertions. For example, confirmation of receivables provides strong, direct evidence about the existence of those receivables and it may provide some evidence about accuracy of the gross balance. However, confirmations alone are not sufficient appropriate audit evidence to test the valuation of receivables, and the auditor should perform other appropriate procedures, such as looking at subsequent cash receipts and applying analytical procedures in testing the allowance for doubtful accounts. For this reason, to establish a clear link between your assessment of the risk of material misstatement and further audit procedures, your risk assessment procedures should be performed at the assertion level as well.

Internal Control

Definition and Description of Internal Control

.50 Internal control is a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives. These objectives fall into three categories: financial reporting, operations, and compliance with laws and regulations. In general, when performing a financial statement audit, you are most concerned with the client's financial reporting objectives, which relate to the preparation of audited financial statements.

.51 In trying to achieve its objectives, your client faces certain risks. Internal control helps the entity achieve its objectives by mitigating the risk of "what can go wrong" in the pursuit of its objectives. Thus, there is a direct link between the entity's objectives, the risks to achieving those objectives, and internal control. Your assessment of internal control is a consideration of whether the controls mitigate financial reporting risks.

.52 Internal control consists of five interrelated components:

1. *Control environment* sets the tone of an organization, influencing the control-consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

2. Entity's *risk assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

3. *Information and communication systems* support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

4. *Control activities* are the policies and procedures that help ensure that management directives are carried out.

5. *Monitoring* is a process that assesses the quality of internal control performance over time.

.53 This division of internal control into five components provides a useful framework for you to consider how different aspects of your client's internal control may affect your audit. You are not required to classify controls into a particular component. Rather, your understanding of internal control involves determining whether and how a specific control may prevent or detect and correct material misstatements.

Controls May Be Pervasive to the Entity or Restricted to an Account or Assertion

.54 Your client's financial reporting risks (and therefore its controls) may relate to one of the following:

1. To specific classes of transactions, account balances, and disclosures

2. More pervasively to the financial statements taken as a whole (And potentially the risks may affect many assertions.)

.55 For example, a weak control environment potentially affects many assertions and therefore is considered to operate at the financial statement level. In contrast, a control to ensure that all valid purchases are captured and recorded is restricted to specific accounts and classes of transactions and thus operates at the assertion level.

.56 Understanding whether a control is restricted to specific classes of transactions, account balances, or disclosures or pertains pervasively to the financial statements will help you:

1. Design appropriate audit procedures to obtain information about the design of the control and whether it has been placed in operation

2. Assess the risk of material misstatement in the financial statements

3. Design substantive audit procedures

4. Assess the results of the tests of operating effectiveness of controls, if any

Control Design

.57 The evaluation of internal control design involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements.

.58 On every audit you should evaluate the design of internal control and determine whether controls have been implemented over all relevant assertions related to each material account balance, class of transactions, or disclosures.

Control Operations

.59 The concept of the effective operation of controls is different from their design and implementation. The operating effectiveness of controls involves the consideration of:

— How controls were applied during the audit period

— The consistency with which they were applied

— By whom they were applied

.60 To assess the operating effectiveness of controls, you should perform tests of controls. Unlike the evaluation of control design, tests of controls are not required on every audit, only on those audits where the auditor's risk assessment procedures includes an expectation that the controls will be effective or when substantive procedures alone do not provide sufficient audit evidence at the assertion level.

Information Technology

.61 Your understanding of the client and its environment, including its internal control, includes an understanding of how it uses information technology (IT). A client'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, compliance objectives, and its operating units or business functions. Examples in which IT affects the entity and its environment are as follows.

- *External factors.* For example, technological innovations may have lowered the barriers to entry into the client's industry, which in turn increases competition not only for customers, but perhaps also for raw materials or qualified personnel.

- *Client operations.* For example, your client's manufacturing process may rely more on manual processes and less on technology than its competitors. Consequently, your client's financial and nonfinancial ratios will differ from others in the industry.
- *Objectives, strategies, and business risks.* For example, your not-for-profit client's innovative use of technology may allow it to raise contributions from groups of supporters who otherwise would not contribute to the organization.
- *Measurement and review of the client's financial performance.* For example, management frequently relies on information produced by the company's IT processing system to measure and review the company's financial performance. Management's ability to make decisions appropriately may rely on the accuracy, availability, and timeliness of the information processed by the IT system.

.62 The way in which IT is deployed may vary among entities. For example, your client 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, other entities in the same industry may have complex, highly integrated systems that share data and that are used to support all aspects of the company.

Implications of IT on Your Understanding of Internal Control

.63 The nature and characteristics of your client's use of IT in its financial information system affect its internal control. For example:

- Multiple users may access a common database of information. 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 breakdown could result in unauthorized transactions or changes to programs or data that affect the financial statements.

.64 ***General vs. IT Application Controls.*** IT general computer controls are polices and procedures that relate to many applications and support the effective functioning and continued proper operation of information systems. For example, your client's administration of passwords can potentially affect many applications. If passwords for a given user can be stored on that person's computer, the effectiveness of internal control may be compromised because anyone who gained access to the computer could inappropriately gain access to the application, the related data, or both.

.65 Other IT controls are applied only to specific applications, for example accounts payable, payroll, or the general accounting application. 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. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and performing manual follow-ups of exception reports.

How the Client's Use of IT Affects Audit Planning

.66 The use of professionals possessing IT skills is a significant aspect of many audit engagements. An IT professional may help:

- Determine the effect of IT on the audit
- Identify and assess IT risks

- Understand IT controls
- Design and perform tests of IT controls or substantive procedures

.67 In determining whether an IT professional is needed on the audit team, you should consider 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

.68 Audit procedures that you may assign to a professional possessing IT skills include:

- Inquiring of the client's IT personnel how data and transactions are initiated, authorized, recorded, processed, and reported and how IT controls are designed
- Inspecting systems documentation
- Observing the operation of IT controls
- Planning and performing tests of IT controls

.69 If the use of an IT professional is planned, you should determine whether that professional is effectively functioning as a member of the audit team. If such a professional is part of your audit team, your responsibilities with respect to that professional are equivalent to those for other assistants. In such circumstances, you should have sufficient knowledge of IT matters to:

1. Communicate the objectives of the IT professional's work
2. Evaluate whether the specified audit procedures will meet your objectives
3. Evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of further planned audit procedures

Audit Evidence

The Nature of Audit Evidence

.70 Audit evidence is all the information you use to arrive at the conclusions that support your audit opinion. Audit evidence is cumulative in nature. For example, your evidence regarding payables begins with you performing risk assessment procedures relating to the client and its environment, including its internal control. These risk assessment procedures provide audit evidence to support your conclusion about the risk of material misstatement for payables. Based on this risk assessment, you then perform further audit procedures, which include substantive tests and may include tests of controls. The results of these further audit procedures provide audit evidence that, when considered in conjunction with the evidence from risk assessment procedures, allow you to form a supportable conclusion about payables. You then repeat this process for other accounts, classes of transactions, and disclosures, and the aggregation of your conclusions provides a basis for your opinion on the financial statements taken as a whole.

.71 The procedures that you perform on your audit provide audit evidence, but they are not the only source of audit evidence. For example, previous audits and your firm's client acceptance and continuance procedures also may be sources of audit evidence.

.72 To determine whether you have obtained persuasive audit evidence, you should consider:

- The consistency of that evidence
- Whether the evidence was obtained from different sources or the performance of procedures that were of a different nature

.73 A lack of consistency among individual items of audit evidence may indicate that one of the items is not reliable. For example, in a not-for-profit entity, the board of trustees' minutes reported that all of the contributions received during the year were unrestricted, but some of the donor agreements examined by you stated that the contributions are temporarily restricted. When audit evidence obtained from one source is inconsistent with that obtained from another, you should determine what additional audit procedures are necessary to resolve the inconsistency.

.74 Ordinarily, you obtain more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of evidence considered individually. For example, reading minutes of the board and other documentation and making inquiries of several individuals about matters included in disclosures usually provide more reliable evidence than does making inquiries of one individual.

The Sufficiency and Appropriateness of Audit Evidence

.75 ***Sufficiency of Audit Evidence.*** The sufficiency of audit evidence relates to its quantity. For example, the auditor who tests eight of the twelve monthly reconciliations between a general ledger control account and the related subsidiary ledger will obtain more evidence about the operating effectiveness of the control than the auditor who tests only two of the twelve reconciliations.

.76 The sufficiency of audit evidence you need to support your conclusion is affected by:

- *The risk of misstatement.* The greater the risk, the more audit evidence likely to be required to support a conclusion
- *The quality of the audit evidence obtained.* The higher the quality of the evidence, the less that will be required.

.77 ***Appropriateness of Audit Evidence.*** The appropriateness of audit evidence relates to its quality. The quality of audit evidence is a function of its relevance and its reliability in providing support, or detecting misstatements, in the accounts, classes of transactions, or assertions.

- *Relevance of audit evidence.* The results of your audit procedures may provide audit evidence that is relevant to certain assertions but not others. For example, tests of controls related to the proper authorization of a transaction will provide evidence about the occurrence assertion but not about the completeness assertion. Obtaining audit evidence relating to a particular assertion, in this example, the occurrence of a transaction, is not a substitute for obtaining audit evidence regarding another assertion, in this example, completeness.
- *Reliability of audit evidence.* The reliability of audit evidence is influenced by its source and by its nature. Reliability also depends on the individual circumstances under which it is obtained, including its timing.

.78 Generalizations about the reliability of various kinds of audit evidence can be made; however, when considering such generalizations keep in mind that they are subject to important exceptions. Even when audit evidence is obtained from sources external to the client, circumstances may exist that could affect the reliability of the information obtained. For example, audit evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful.

- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence is more reliable when it exists in documentary form (whether paper, electronic, or other medium). For example, minutes of an audit committee meeting are more reliable than a subsequent oral representation of the matters discussed at the meeting.
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

.79 Typically, you obtain more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, if the company lacks documentation to support its intent with regard to equity securities (which affect how those securities are classified and presented in the financial statements), you may have no choice but to rely on management's representations regarding their intent. Management's representations may be less reliable than a written record, but if you obtain representations from several sources (for example, from different members of management) and these representations are consistent with the client's past history of selling equity investments, then you may find the consistency of the evidence from different sources to be persuasive.

.80 An increased quantity of audit evidence may compensate for less reliable audit evidence, it cannot compensate for audit evidence that lacks relevancy. For example, a confirmation of an accounts receivable balance is not relevant to the valuation of the allowance account. Increasing the number of receivables confirmations will not provide you with any additional evidence relating to the allowance for doubtful accounts.

.81 ***Determining Whether You Have Obtained Sufficient, Appropriate Audit Evidence.*** You may find it necessary to rely on audit evidence that is persuasive rather than conclusive. However, to obtain the reasonable assurance required to support an opinion about the financial statements, you must not be satisfied with audit evidence that is less than persuasive.

Part Three: Applying the Audit Risk Model

.82 This part of the Alert provides a summary of the audit process. Even though some requirements and guidance are presented in a way that suggests a sequential process, audit fieldwork involves a continuous process of gathering, updating, and analyzing information throughout the audit.

.83 The following is an overview of how an auditor should apply the audit risk model in practice.

- *Gather information about the entity and its environment, including internal control.* Your first step in the process is to gather information about those aspects of the client and its environment that will allow you to identify and assess risks. Evaluating the design of the client's controls and determining whether they have been implemented are an integral part of this process.

- *Understand the entity and its environment, including its internal control.* Based on the information gathered, you should be able to identify what could go wrong in specific relevant assertions related to each account balance, class of transactions, or disclosures.

- *Assess the risk of material misstatement.* Next, you will use your understanding of the client and its environment, including its internal control, to assess the risk of material misstatement that relate to both financial statement level and specific assertions. To assess risks you will need to:

  — Identify the risk of material misstatement

  — Describe the identified risks in terms of what can go wrong in specific assertions

  — Consider the significance and likelihood of material misstatement for each identified risk

- *Design overall responses and further audit procedures.* You should address the risk of material misstatement at both the financial statement and the relevant assertion level.

  — The risk of material misstatement at the financial statement level has a more pervasive effect on the financial statements and affects many assertions. In addition to developing assertion-specific responses, financial statement-level risks may require you to develop an overall, audit-wide response, such as assigning more experienced audit team members.

  — Assertion-level risks pertain to a single assertion and should be considered when you design and subsequently perform further audit procedures. Depending on the results of your risk assessment procedures, further audit procedures may encompass a combined approach using both tests of controls and substantive procedures or a substantive audit approach. Either approach is directed at relevant assertions related to each material account balance, class of transactions, and disclosures. However, regardless of your assessment of risks, you need to perform substantive audit procedures on all relevant assertions related to each material account balance, class of transaction, or disclosure.

Information Gathering

Information Needed About the Client and Its Environment to Identify and Assess the Risk of Material Misstatement

.84 Obtaining an understanding of your client and its environment is an essential part of every audit. Not only does this understanding allow you to identify and assess the risk of material misstatement, it also allows you to exercise informed judgment about other audit matters such as:

- Materiality
- Whether the client's selection and application of accounting policies are appropriate and financial statement disclosures are adequate
- Areas where special audit consideration may be necessary, for example, related party transactions
- The expectation of recorded amounts that you develop for performing analytical procedures
- The design and performance of further audit procedures
- The evaluation of audit evidence

.85 Not all information about a client or its environment is relevant for your audit. In general, the information you should gather about your client is that which allows you to assess the risk that specific assertions could be materially misstated. The following table summarizes the various categories of information you should obtain about your client.

Understanding the Client and Its Environment

On every audit you are required to gather information and obtain an understanding of the client and its environment. This understanding consists of the following aspects.

- *External factors*, including
  - — Industry factors such as the competitive environment, supplier and customer relationships, and technological developments.
  - — The regulatory environment, which includes relevant accounting pronouncements, the legal and political environment, and environmental requirements that affect the industry.
  - — Other matters such as general economic conditions.
- *Nature of the client*, which includes its operations, its ownership, governance, the types of investments it makes and plans to make, how it isfinanced, and how it is structured.
- *Objectives and strategies and related business risks*, which may result in material misstatement of the financial statements taken as a whole or individual assertions.
- *Measurement and review of the client's financial performance*, which tells you which aspects of the client's performance that management considers to be important.
- *Internal control*, which consists of five components: the control environment, risk assessment, information and communication, control activities, and monitoring. These components may operate at the entity level or the individual transaction level. To obtain an appropriate understanding of internal control will require you to understand and evaluate the design of all five components of internal control and to determine whether the controls are in use by the client.

Risk Assessment Procedures

.86 The audit procedures you perform to obtain an understanding of the entity and its internal control are referred to as *risk assessment procedures*. Some of the information you obtain by performing risk assessment procedures you will use to support your assessments of the risks of material misstatement. Risk assessment procedures include:

1. Inquiries of management and others at the client

2. Analytical procedures

3. Observation and inspection

.87 You need to gather audit evidence to support your assessment of the risk of material misstatement. It is not acceptable to simply deem control risk to be "at the maximum" without support. Your risk assessment procedures provide the audit evidence necessary to support your risk assessments, which in turn, support your determination of the nature, timing, and extent of further audit procedures. Thus, the results of your risk assessment procedures are an integral part of the audit evidence you obtain to support your opinion on the financial statements.

.88 ***A Mix of Procedures.*** Except for internal control, you are not required to perform all the procedures for each of the five aspects of the client and its environment discussed previously. However, in the course of gathering information about the client, you should perform all the risk assessment procedures.

.89 With regard to obtaining an understanding about the design of internal control and determining whether they have been implemented, inquiry alone is not sufficient. Thus, for these purposes, you should supplement your inquiries with other risk assessment procedures.

.90 ***Other Procedures That Provide Relevant Information About the Client.*** Following include some procedures you might consider.

- *Assessing the Risk of Material Misstatement Due to Fraud.* AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), directs you to perform certain audit procedures to assess the risk of material misstatement due to fraud. Some of these procedures also may help gather information about the entity and its environment, particularly its internal control. For this reason, you should:
  - — Coordinate the procedures you perform to assess the risk of material misstatement due to fraud with your other risk assessment procedures
  - — Consider the results of your assessment of fraud risk when identifying the risk of material misstatement
- *Other Information.* When relevant to the audit, you also should consider other knowledge you have of the client that can help you assess risk. This other information may include:
  - — Information obtained from your client acceptance or continuance process
  - — Experience gained on other engagements performed for the entity

.91 ***Updating Information From Prior Periods.*** If certain conditions are met, you may use information about the client you obtained in prior periods as audit evidence in the current period audit. However, when you intend to use information from prior periods in the current period audit, you should determine whether changes have occurred that may affect the relevance of the information for the current audit. To make this determination, you should make inquiries and perform other appropriate audit procedures, such as walk-throughs of systems.

Gaining an Understanding of the Client and Its Environment

.92 The gathering of information, by itself, does not provide you with the understanding of the client that is necessary for you to assess risk. For you to assess the risk of material misstatement and perform further audit procedures, you need to synthesize the information gathered to determine how it might affect the financial statements. For example:

- Information about the client's industry may allow you to identify characteristics of the industry that could give rise to specific misstatements. For example, if your client is a construction contractor that uses long-term contract accounting, your understanding of the client should be sufficient to allow you to recognize that the significant estimates of revenues and costs create a risk of material misstatement.
- Information about the ownership of your client, how it is structured, and other elements of its nature will help you identify related party transactions that, if not properly accounted for and adequately disclosed, could lead to a material misstatement.
- Your identification and understanding of the business risks facing your client increase the chance that you will identify financial reporting risks. For example, your client may face a risk that a new company may enter its market, and that new entrant could have certain business advantages (for example, economies of scale or greater brand recognition). The potential risk of material misstatement of the financial statements related to this business risk might be obsolescence or overproduction of inventory that could only be sold at a discount.
- Information about the performance measures used by client management may lead you to identify pressures or incentives that could motivate client personnel to misstate the financial statements.
- Information about the design and implementation of internal control may lead you to identify deficiencies in control design, which increase the risk of material misstatement.

Evaluating the Design of Internal Control

.93 A sufficient understanding of internal control is one that allows you to evaluate the design of internal control and to determine whether controls have been placed in operation. This threshold describes a substantial understanding of internal control.

Requirements for Evaluating Control Design

.94 On every audit, you should obtain an understanding of internal control that is of sufficient depth to enable you to:

1. Assess the risks of material misstatement of the financial statements, whether due to error or fraud

2. Design the nature, timing, and extent of further audit procedures

.95 To meet this threshold of sufficiency, at both the entity and relevant assertion level, you should:

1. Evaluate the design of controls that are relevant to the audit and determine whether the control—either individually or in combination—is capable of effectively preventing or detecting and correcting material misstatements.

2. Determine that the control has been implemented, that is, that the control exists and that the entity is using it.

.96 Your evaluation of internal control design and the determination of whether controls have been implemented are critical to your assessment of the risks of material misstatement. It is not possible to develop a reliable assessment of the risk of material misstatement absent a sufficient understanding of internal control. For this reason, you are required to perform risk assessment procedures to gather information and form an understanding of internal control on every audit. Even if your initial audit strategy contemplates performing only substantive procedures for all relevant assertions related to material transactions, account balances, and disclosures, you still need to evaluate the design of your client's internal control.

.97 ***How to Evaluate Control Design.*** In evaluating control design, it is helpful to consider:

- Whether control objectives that are specific to the unique circumstances of the client have been considered for all relevant assertions for all significant accounts and disclosures

- Whether the control or combination of controls would—if operated as designed—meet the control objective

- Whether all controls necessary to meet the control objective are in place

Determining If the Control Has Been Implemented

.98 It may be possible that the way in which a control is applied by an entity differs from the description of the control in a policy manual or from one individual's understanding of how the control is applied. For example, your client's accounting policy manual may state that physical inventory accounts are performed annually. However, because of increases in the volume of transactions, the client deviates from this stated policy and counts some inventory items twice a year. This practice is not reflected in the policy manual and is not known by all individuals in the company. Determining whether a control has been implemented is important because it confirms your understanding of control design.

.99 The determination of whether a control has been put in place and is in use involves obtaining evidence about whether those individuals responsible for performing the prescribed procedures have:

- An awareness of the existence of the procedure and their responsibility for its performance
- A working knowledge of how the procedure should be performed

.100 Determining whether the control has been implemented does not require you to determine whether the control was performed properly throughout the audit period.

.101 ***Distinguishing Between Evaluation of Design and Tests of Controls.*** Obtaining an understanding of the design and implementation of internal control is different from testing its operating effectiveness.

- *Understanding design and implementation* is required on every audit as part of the process of assessing the risks of material misstatement.
- *Testing the operating effectiveness* builds on your understanding of internal control design and implementation and is necessary only where the auditor's risk assessment procedures include an expectation that the controls will be effective or when substantive procedures alone do not provide you with sufficient audit evidence at the assertion level.

.102 The procedures necessary to understand the design and implementation of controls do provide some limited evidence regarding the operation of the control.[2]

.103 However, the procedures necessary to understand the design and implementation of controls generally are not sufficient to serve as a test of their operating effectiveness for the purpose of placing significant reliance on their operation. For example, obtaining audit evidence about the implementation of a manually operated control at a point in time does not provide audit evidence about the operating effectiveness of control at other times during the period under audit.

.104 Examples of situations where the procedures you perform to understand the design and implementation of controls may provide sufficient audit evidence about their operating effectiveness include:

- Controls that are automated to the degree that they can be performed consistently provided that IT general controls over those automated controls operated effectively during the period.
- Controls that operate only at a point in time rather than continuously throughout the period. For example, if the client performs an annual physical inventory count, your observation of that count and other procedures to evaluate its design and implementation provide you with evidence that you consider in the design of your substantive procedures.

.105 ***Evaluating Design and Implementation in the Absence of Control Documentation.*** For smaller companies, the company's evidence supporting the design and implementation of some elements of internal control may not be available in documentary form. For example, the entity may lack:

- A written code of conduct that describes management's commitment to ethical values
- A formal risk assessment process

.106 Without adequate documentation of controls, the risk assessment procedures available to you to understand control design are limited to inquiry and observation. As risk assessment procedures, both inquiry and observation have limitations, and accordingly, absent adequate documentation, you should consider whether the information you have gathered about internal control is sufficient to evaluate its design.

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[2] For example, a walkthrough that traces a transaction from its inception through its recording is considered a test of one transaction. Examination of several documents evidencing the operation of a control at a key control point may also be considered as a test. Generally, the evidence required to rely on the operation of the control will be greater than that required to simply assess whether it has been placed in operation.

.107 Inadequate documentation of the components of internal control also may be a control deficiency. For example, the lack of appropriate documentation may impair management's ability to communicate control procedures to those responsible for their performance or to monitor control performance effectively.

Discussion Among the Audit Team

.108 The members of the audit team should discuss the susceptibility of the client's financial statements to material misstatement. This discussion will allow team members to exchange information and create a shared understanding of the client and its environment, which in turn will enable each team member to:

- Gain a better understanding of the potential for material misstatement resulting from fraud or error in the assertions that are relevant to the areas assigned to them
- Understand how the results of the audit procedures that they perform may affect other aspects of the audit.

This discussion among the audit team could be held at the same time as the discussion among the team related to fraud, which is required by AU section 316.

Assessing the Risk of Material Misstatement

Considerations at the Financial Statement Level

.109 You should use your understanding of the client and its environment—which includes your evaluation of the design and implementation of internal control—to assess the risk of material misstatement. To make this assessment, you should:

1. Identify risks throughout the process of obtaining an understanding of the entity, its internal control, and its environment.
2. Relate the identified risks to what can go wrong at the relevant assertion level.
3. Consider whether the risks could result in a material misstatement to the financial statements.
4. Consider the likelihood that the risks could result in a material misstatement of the financial statements.

.110 ***Financial Statement-Level and Assertion-Level Risks.*** You should identify and assess the risks of material misstatement at both the financial statement level and the relevant assertion level.

1. *Financial statement-level risks.* Some risks of material misstatement relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. These risks at the financial statement level may be identifiable with specific assertions at the class of transaction, account balance, or disclosure level.
2. *Relevant assertion-level risks.* Other risks of material misstatement relate to specific classes of transactions, account balances, and disclosures at the assertion level. Your assessment of risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures.

.111 Risks that exist at the financial statement level, for example, those that pertain to a weak control environment or to management's process for making significant accounting estimates, should be related to specific assertions. For example, risks related to the client's process for making accounting estimates would affect those assertions where an accounting estimate was necessary (for example, the valuation of assets).

.112 In other instances, it may not be possible for you to relate your financial statement-level risks to a particular assertion or group of assertions. For example, it may not be possible for you to determine which assertions will or will not be affected by a weak control environment. Financial statement-level assertions that can not be related to specific assertions will require you to make an overall response, such as the way in which the audit is staffed or supervised.

.113 ***How to Consider Internal Control When Assessing Risks.*** Your evaluation of internal control design and the determination of whether controls have been implemented are integral components of the risk assessment process. When making risk assessments, you should identify the controls that are likely to either prevent or detect and correct material misstatements in specific assertions. For example, procedures relating to the client's physical inventory count may relate specifically to the existence or completeness of inventory.

.114 Individual controls often do not address a risk completely in themselves. Often, only multiple control activities, together with other components of internal control (for example, the control environment, risk assessment, information and communication, or monitoring), will be sufficient to address a risk. For this reason, when determining whether identified controls are likely to prevent or detect and correct material misstatements, you generally organize your risk assessment procedures according to significant transactions and accounting processes (for example, sales, cash receipts, or payroll), rather than general ledger accounts.

.115 ***Identification of Significant Risks.*** As part of your risk assessment, you should identify significant risks, which are defined as those risks that require special audit consideration. For example, if your client is named as a defendant in a patent infringement lawsuit that may threaten the viability of its principal product, you could consider as significant risks, the risks that the lawsuit (1) would not be appropriately recorded or disclosed in accordance with generally accepted accounting principles or (2) may affect the entity's ability to continue as a going concern.

.116 Significant risks arise on most audits. When you determine that a risk is a significant risk, your audit procedures should include (but not be limited to):

- Obtaining an understanding of internal control, including relevant control activities, related specifically to those significant risks.
- If you plan to rely on the operating effectiveness of controls related to significant risks, testing the operating effectiveness of those controls in the current period. That is, using evidence about operating effectiveness that you obtained in prior periods is not appropriate.
- Substantive procedures specifically designed to address the significant risk.

.117 Significant risks should be distinguished from transactions or events that have a high inherent risk, which could be mitigated by the client's internal controls. For example, because of the nature of your client and the industry in which it operates, you might assess a high inherent risk on revenue recognition. However, the client may have controls over revenue recognition; you would then obtain an understanding of such controls and determine whether they are implemented and, if appropriate, test their operating effectiveness. This circumstance may not warrant special audit consideration and thus may not be a significant risk.

.118 The determination of whether a transaction or event is a significant risk is a matter for your professional judgment.

Considerations at the Assertion Level

.119 Part Two of this Alert provides a definition of audit risk (AR) in which:

AR = RMM x DR

where RMM is the risk of material misstatement and DR is detection risk

The risk of material misstatement is described as "the entity's risk," which means that it is independent of your audit. You can control detection risk by changing the nature, timing, and extent of your audit procedures. For example, to decrease the planned level of detection risk, you could perform more extensive substantive tests.

.120 You cannot control the risk of material misstatement as you can detection risk because RMM exists independently from your audit procedures. However, to properly gauge the detection risk you are willing to accept, you need to assess the risks of material misstatement. The risk assessment process described in the SASs is designed to allow you to gather information and assess the risks of material misstatement so you can design further audit procedures that reduce audit risk to an acceptably low level.

Determining Materiality and Tolerable Misstatement

.121 You should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. The determination of materiality will assist you in (1) making judgments when identifying and assessing the risk of material misstatement and (2) determining the nature, timing, and extent of your further audit procedures. In determining financial statement materiality, you will often apply percentages to benchmarks. The determination of materiality, including the selection of the appropriate benchmark and percentages, is a matter of your professional judgment and depends on the nature and circumstances of your audit.

.122 In addition to the quantitative considerations, you should be alert for misstatements that could be qualitatively material, for example, misstatements that may change a loss into income or vice versa, may potentially affect loan covenants, or may increase management's compensation.

.123 After you determine the financial statement materiality, you should set a tolerable misstatement, which is the adjustment of the financial statement materiality to the assertion level. Tolerable misstatement will assist you in assessing the risk of material misstatement and in designing and performing further audit procedures.

.124 Because the entity's circumstances may change as the audit progresses, you should reassess the financial statement materiality and tolerable misstatement levels initially determined. Failure to do so may result in you failing to obtain sufficient audit evidence to support your opinion.

Responding to Assessed Risks

Linking Assessed Risks to Further Audit Procedures

.125 The risk assessment process culminates with your articulation of the account balances, classes of transactions, or disclosures where material misstatements are most likely to occur. This assessment of risk relates identified risks to what can go wrong at the assertion level and the way in which misstatements are likely to occur. Your risk assessment provides the basis for designing and performing further audit procedures.

.126 You can think of your assessment of risks as having two dimensions: direction and amplitude. Direction relates to where misstatements can occur, that is, the specific assertions related to an account, class of transactions, or disclosure. Amplitude relates to the possible magnitude of the misstatement that could occur. Magnitude is a function of two variables: the potential significance of the misstatement (for example, whether it is material) and the likelihood of a misstatement occurring (for example, remote, likely). Your evaluation of the design and implementation of internal control affects all elements of your risk assessment process.

Further Audit Procedures

.127 You perform further audit procedures to obtain the audit evidence necessary to support your audit opinion. Further audit procedures consist of either tests of controls or substantive tests. Often, a combined approach using both tests of controls and substantive procedures is an effective approach. You are not precluded from adapting a substantive audit approach provided that you have and document an appropriate basis for this approach.

.128 In determining the nature, timing, and extent of further audit procedures, you should design and perform further procedures whose nature, timing, and extent are responsive to the assessed risk of material misstatement at the relevant assertion level. You should provide and document a clear linkage between your assessment of the risk of material misstatement and the nature, timing, and extent of the further audit procedures.

.129 Audit procedures performed in previous audits and example procedures provided by illustrative audit programs may help you understand the types of further audit procedures that are possible for you to perform. However, prior year procedures and example audit programs do not provide a sufficient basis for determining the nature, timing, and extent of audit procedures to perform in the current audit. Your assessment of the risk of material misstatement in the current period is the primary basis for designing further audit procedures in the current period.

Evaluating Audit Findings

.130 In evaluating whether the financial statements are presented fairly, you must consider the effects, both individually and in the aggregate, of misstatements (known and likely) identified by you that are not corrected by the client.

.131 Your consideration and aggregation of misstatements should include both of the following:

- Known misstatements, which are the amount of misstatements specifically identified
- Likely misstatements, which include (1) projected misstatements in the account balances or classes of transactions that you have examined and (2) differences between management's and the auditor's judgments concerning accounting estimates that the auditor considers unreasonable or inappropriate.

.132 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.

.133 Before considering the aggregate effect of identified uncorrected misstatements, the auditor should consider each misstatement separately to evaluate:

1. Its effect in relation to the relevant individual classes of transactions, account balances, or disclosures, including qualitative considerations.
2. Whether, in considering the effect of the individual misstatement on the financial statements taken as a whole, it is appropriate to offset misstatements. For example, it may be appropriate to offset misstatements of items within the same account balance in the financial statements.
3. The effect of misstatements related to prior periods. In prior periods, misstatements may not have been corrected by the entity because they did not cause the financial statements for those periods to be materially misstated. Those misstatements might also affect the current period's financial statements.

.134 In aggregating misstatements, you should include the effect on the current period's financial statements of those prior period misstatements. When evaluating the aggregate uncorrected misstatements, you should consider the effects of these uncorrected misstatements in determining whether the financial statements are free of material misstatement.

.135 There are quantitative and qualitative materiality considerations, and you should consider both when evaluating audit results. Because of qualitative considerations, misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

Evaluating Whether the Financial Statements Taken as a Whole Are Free of Material Misstatement

.136 You must evaluate whether the financial statements taken as a whole are free of material misstatement. In making this evaluation, you should consider the evaluation of the uncorrected (known and likely) misstatements you identified during the audit. When concluding about whether the effect of misstatements, individually or in the aggregate, is material, you should consider the nature and amount of the misstatements in relation to the nature and amount of items in the financial statements under audit. For example, an amount that is material to the financial statements of one entity may not be material to the financial statements of another entity of a different size or nature. Also, what is material to the financial statements of a particular entity might change from one period to another.

.137 If you believe that the financial statements taken as a whole are materially misstated, you should request management to make the necessary corrections. If management refuses to make the corrections, you must determine the implications for the auditor's report.

.138 If you conclude that the effects of uncorrected misstatements are not material, you should consider that the financial statements themselves could still be materially misstated because of additional misstatements that you did not detect. As the aggregate misstatements approach materiality, the risk that the financial statements may be materially misstated also increases. Accordingly, you should consider the effect of undetected misstatements in concluding whether the financial statements are fairly stated.

The Iterative Nature of Auditing

.139 An audit of financial statements is a cumulative and iterative process. As you perform planned audit procedures—whether they be risk assessment procedures, substantive tests, or tests of controls—the audit evidence you obtain may cause you to modify the nature, timing, or extent of other planned audit procedures. Information may come to your attention that differs significantly from the information on which the risk assessments were based.

.140 For example, the extent of misstatements that you detect by performing substantive procedures may alter your judgment about the risk assessments and may indicate a material weakness in internal control. Or, analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement. In such circumstances, you should reevaluate the planned audit procedures based on the revised consideration of assessed risks.

Audit Documentation

General Documentation Requirements

.141 In general, you should document certain matters pertaining to each step in the risk assessment process. This audit documentation should provide a clear understanding of the work performed, the source of the information, and the conclusions reached.

.142 The form and content of audit documentation are for you to determine using professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), provides general guidance regarding the purpose, content, ownership, and confidentiality of audit documentation. Examples of common documentation techniques include narrative descriptions, questionnaires, checklists, and flowcharts. These techniques may be used alone or in combination.

.143 The form and extent of your documentation are influenced by the following:

- The nature, size, and complexity of the entity and its environment
- The availability of information from the entity
- The specific audit methodology and technology used in the course of the audit

.144 For example, documentation of the understanding of a complex information system in which a large volume of transactions are electronically initiated, authorized, 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, documentation in the form of a memorandum may be sufficient. Generally, the more complex the entity and its environment, and the more extensive the audit procedures performed by the auditor, the more extensive your documentation should be. The specific audit methodology and technology used in the course of the audit will also affect the form and extent of documentation.

Specific Documentation Requirements

.145 The SASs require you to document the following matters.

- The levels of materiality and tolerable misstatement, including any changes thereto, used in the audit and the basis on which those levels were determined.
- The discussion among the audit team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud, including how and when the discussion occurred, the subject matter discussed, the audit team members who participated, and significant decisions reached concerning planned responses at the financial statement and relevant assertion levels.
- Key elements of the understanding obtained regarding each of the aspects of the entity and its environment, including each of the components of internal control, to assess the risks of material misstatement of the financial statements, the sources of information from which the understanding was obtained, and the risk assessment procedures.
- The assessment of the risks of material misstatement both at the financial statement level and at the relevant assertion level and the basis for the assessment.
- The significant risks identified and related controls evaluated.
- The overall responses to address the assessed risks of misstatement at the financial statement level.
- The nature, timing, and extent of the further audit procedures.
- The linkage of those procedures with the assessed risks at the relevant assertion level.
- The results of the audit procedures.
- The conclusions reached with regard to the use in the current audit of audit evidence about the operating effectiveness of controls that was obtained in a prior audit.
- A summary of uncorrected misstatements, other than those that are trivial, related to known and likely misstatements.
- Your conclusion about whether uncorrected misstatements, individually or in aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion.

.146 Uncorrected misstatements should be documented in a manner that allows the auditor to:

- Separately consider the effects of known and likely misstatements, including uncorrected misstatements identified in prior periods.
- Consider the aggregate effect of misstatements on the financial statements.
- Consider the qualitative factors that are relevant to the auditor's consideration of whether misstatements are material.

Resource Central

.147 The AICPA will offer continuing professional education courses, including a self-study course as well as a group study course. In addition, the new risk assessment standards will be a topic of discussion in various AICPA conferences in which AICPA presenters will further explain the standards.

On the Bookshelf

Future AICPA Audit Guide on Risk Assessment and Internal Control

.148 The AICPA is currently developing an Audit Guide to aid in implementing the new risk assessment standards. In addition, the AICPA is revamping its existing Audit Guide titled *Consideration of Internal Control in a Financial Statement Audit*. The current development plan envisions combining these two guides into one audit guide. This audit guide should be available by mid-2006 and can be purchased by contacting the AICPA/CPA2Biz Service Center at (888) 777-7077 or online at www.cpa2biz.com.

AICPA's reSOURCE Online Accounting and Auditing Literature

.149 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.

reSOURCE CD-ROM

.150 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 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.

AICPA/CPA2Biz Service Center

.151 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA/CPA2Biz Service Center at (888) 777-7077. 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. You can also order AICPA products from the Service Center by fax at (800) 362-5066 or visit www.cpa2biz.com to obtain product information and place online orders.

Hotlines

Accounting and Auditing Technical Hotline

.152 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.153 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

.154 AICPA Online (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 and Accounting Guides*, *Professional Standards*, CPE courses, Practice Aids, and Audit Risk Alerts.

.155 Any comments that you have about this Alert may be e-mailed to lpombo@aicpa.org or mailed to:

Lori Pombo, CPA
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

[*The next page is 9000-251.*]

AAM Section 8300

Understanding SAS No. 112 and Evaluating Control Deficiencies

COMPANION TO SAS N0. 112, COMMUNICATING INTERNAL CONTROL RELATED MATTERS IDENTIFIED IN AN AUDIT

NOTICE TO READERS
UNDERSTANDING SAS NO. 112 AND EVALUATING CONTROL DEFICIENCIES

This Audit Risk Alert, prepared by the AICPA staff, is intended to help you understand and implement the requirements of Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

This publication is an *Other Auditing Publication* as defined in AU section 150, *Generally Accepted Auditing Standards*. 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.

The author gratefully acknowledges the contributions of the AICPA Technical Issues Committee in the development of this Audit Risk Alert.

Ahava Goldman, CPA
Technical Manager
Audit and Attest Standards

Introduction

.01 In May 2006, the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended.

.02 The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. This Audit Risk Alert provides an overview of the requirements of SAS No. 112 as well as case studies that illustrate how control deficiencies may be evaluated for severity.

Why SAS No. 112 Was Issued

.03 The Sarbanes-Oxley Act of 2002 and the issuance of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, AU sec. 320), created considerable interest in management's responsibility for internal control and the auditor's responsibility for bringing certain internal control related matters to management's attention in an audit of financial statements. Auditing Standard No. 2 only applies to audits conducted in accordance with PCAOB standards. Generally, this means that Auditing Standard No. 2 applies to audits of public companies (issuers[1]). However, the issuance of Auditing Standard No. 2 created a desire on the part of nonissuers to better understand and evaluate control deficiencies.

.04 The ASB revised SAS No. 60 because it believed there was a need to reconsider and clarify the internal control matters that auditors must communicate to their audit clients. The ASB recognized that auditors were perceived to be inconsistent in communicating the significant deficiencies and material weaknesses identified in prior audits that had not yet been remediated. The ASB also concluded that generally accepted auditing standards (GAAS) should require auditors to communicate these matters in writing, rather than continue to provide auditors with the option of communicating them orally. To achieve greater consistency with Auditing Standard No. 2, the ASB decided that certain terms and definitions in SAS No. 60 should be replaced with the corresponding terms and definitions in Auditing Standard No. 2. Finally, the ASB concluded that it would be beneficial to incorporate some of the guidance in Auditing Standard No. 2 on evaluating control deficiencies that would be applicable to audits of nonissuers.

Overview of the Standard

.05 In general, SAS No. 112 provides guidance to enhance your ability to identify and evaluate control deficiencies during an audit, and then communicate to management and those charged with governance those deficiencies that you believe are *significant deficiencies* or *material weaknesses*.

.06 The standard has two unconditional requirements:

- The auditor must evaluate identified control deficiencies and determine whether those deficiencies, individually or in combination, are significant deficiencies or material weaknesses.
- The auditor must communicate, in writing, significant deficiencies and material weaknesses to management and those charged with governance. This communication includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated.

Change From SAS No. 60

Your communication to management and those charged with governance must be in writing.

Even if you communicated specific significant deficiencies and material weaknesses in previous years, as long as those deficiencies continue to exist, you must continue to communicate them.

The new standard provides guidance on evaluating the severity of control deficiencies identified in an audit.

Identifying Control Deficiencies

.07 A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis:

[1] An *issuer* is an entity subject to the provisions of the Sarbanes-Oxley Act of 2002 or the rules of the Security and Exchange Commission (SEC). Nothing in the PCAOB's rules precludes a CPA from conducting an audit of a nonissuer in accordance with PCAOB standards and stating so in the auditor's report.

- A deficiency in *design* exists when (*a*) a control necessary to meet the control objective is missing or (*b*) an existing control is not properly designed so that, even if it operates as designed, the control objective is not always met.

- A deficiency in *operation* exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

The Auditor's Responsibility for Identifying Control Deficiencies

.08 When conducting an audit of historical financial statements, you are not required to perform procedures to identify control deficiencies. However, during the course of the audit, you may become aware of deficiencies in the design or operation of the entity's internal control. You may identify control deficiencies at any point in your audit, for example, when you are:

- Obtaining an understanding of the entity's internal control,
- Assessing the risks of material misstatement of the financial statements, due to error or fraud,
- Performing further audit procedures to respond to assessed risk, or
- Communicating with management or others (for example, internal auditors or governmental authorities).

.09 Your awareness of control deficiencies will vary with each audit and will be influenced by the nature, timing, and extent of audit procedures performed, as well as other factors. The results of your substantive procedures may cause you to reevaluate your earlier assessment of internal control.

Evaluating Control Deficiencies

Change From SAS No. 60

The term *reportable condition* is no longer used. The terms *significant deficiency* and *material weakness* are used to describe control deficiencies that must be communicated to management and those charged with governance.

.10 A control deficiency may be considered just a deficiency. More severe deficiencies are *significant deficiencies*, and the most severe deficiencies are *material weaknesses*.

Definitions of Significant Deficiency and Material Weakness

.11 A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles (GAAP) such that there is more than a remote[2] likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.

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[2] The term *remote likelihood* as used in the definitions of the terms *significant deficiency* and *material weakness* has the same meaning as the term *remote* as used in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. Paragraph 3 of FASB Statement No. 5 states:

> When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:
> a. *Probable*. The future event or events are likely to occur.
> b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
> c. *Remote*. The chance of the future event or events occurring is slight.

Therefore, the likelihood of an event is "more than remote" when it is at least reasonably possible.

.12 A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

The Evaluation Process

Change From SAS No. 60

You must evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses. In making your evaluation, you link identified control deficiencies to actual or potential financial statement misstatements.

Additional guidance is provided in SAS No. 112 on evaluating control deficiencies to determine whether they are significant deficiencies or material weaknesses.

.13 You must evaluate the control deficiencies that you have identified and determine whether these deficiencies, individually or in combination with other control deficiencies, rise to the level of significant deficiencies or material weaknesses. The significance of a deficiency in internal control depends on the *potential* for misstatement in the financial statements being audited, not just on whether a misstatement has actually occurred. If you identify a control deficiency but you have not identified an actual misstatement related to that deficiency, you cannot automatically conclude that the deficiency is not a significant deficiency or a material weakness. If you have identified a misstatement, you should consider the potential for further misstatement in the financial statements being audited.

Factors to Consider

.14 The factors that you should consider when evaluating control deficiencies are:

- Likelihood, and
- Magnitude

.15 *Likelihood* refers to the probability that a control, or combination of controls, could have failed to prevent or detect a misstatement in the financial statements being audited. If, in your professional judgment, it is at least reasonably possible that a misstatement could have occurred because of a missing control, or because of the failure of a control or combination of controls, then the likelihood is *more than remote*. The existence of a design weakness, in and of itself, is sufficient to conclude that there is more than a remote likelihood that the control would not have been effective. Likewise, if a deficiency resulted in an actual misstatement, you will be better able to determine the likelihood, because it actually happened.

.16 *Magnitude* refers to the extent of the misstatement that could have occurred, or that actually occurred, since misstatements include both potential and actual misstatements. The magnitude of a misstatement may be inconsequential, more than inconsequential but less than material, or material, as shown in the following:

Inconsequential ⟶ More than Inconsequential ⟶ Material

.17 A misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person would not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential.

.18 The difference between a significant deficiency and a material weakness is the magnitude of the misstatement that could have occurred because of the failure of the control to prevent or detect a misstatement. If the magnitude of the actual or potential misstatement is less than material but more than inconsequential, the control deficiency is a significant deficiency. If the misstatement would have been material to the financial statements, the control deficiency is a material weakness. In this evaluation, it does not matter if a misstatement did not actually occur; what is relevant is the potential for misstatement.

.19 You should consider qualitative and quantitative factors in determining whether a misstatement or potential misstatement is more than inconsequential. For example, for the purpose of evaluating control deficiencies, a potential misstatement that is less than 20 percent of overall financial statement materiality may be considered inconsequential, before considering qualitative factors. However, a potential misstatement that is less than 20 percent of overall financial statement materiality may be considered more than inconsequential as a result of qualitative factors; for example, a potential misstatement that would change a loss into income, or result in violation of a loan covenant.

.20 The following table summarizes how you consider the significance of a deficiency to determine whether it is a control deficiency, a significant deficiency, or a material weakness.

Magnitude of misstatement that occurred, or could have occurred	***Likelihood of misstatement***	
	More Than Remote	*Remote*
Quantitatively or qualitatively material	Material weakness	Control deficiency but not a significant deficiency or a material weakness
More than inconsequential but less than material	Significant deficiency but not a material weakness	Control deficiency but not a significant deficiency or a material weakness
Inconsequential (i.e., clearly immaterial)	Control deficiency but not a significant deficiency or a material weakness	Control deficiency but not a significant deficiency or a material weakness

Multiple Control Deficiencies

.21 Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness, even though such deficiencies are individually insignificant. Accordingly, you should evaluate individual control deficiencies that affect the same account balance, disclosure, relevant assertion, or component of internal control to determine whether they collectively result in a significant deficiency or material weakness.

Mitigating Effects of Compensating Controls

.22 When a control deficiency has been identified, management and the auditor should also evaluate the possible mitigating effects of compensating controls. Only those compensating controls that you have tested and evaluated as part of the financial statement audit can be considered for mitigation. A compensating control is a control that limits the severity of a control deficiency and prevents it from rising to the level of a significant deficiency or, in some cases, a material weakness. Compensating controls operate at a level of precision, considering the possibility of further undetected misstatements, which would result in the prevention or detection of a misstatement that is more than inconsequential or material to the financial statements. Although compensating controls mitigate the effects of a control deficiency, they do not eliminate the control deficiency.

.23 For example, consider a situation in which there is a lack of segregation of duties within the accounts payable function in an owner-managed entity. As a compensating control, the owner reviews the supporting documentation for all disbursements exceeding one thousand dollars. As part of your audit, you could test this compensating control and determine whether it operates effectively for the purpose of mitigating the effects of the control deficiency (lack of segregation of duties) in the accounts payable function. Although the control deficiency still exists—the review does not eliminate the lack of segregation of duties—the significance of the deficiency may be mitigated by the compensating control so that it is not a significant deficiency or a material weakness.

The Prudent Official Test

.24 When you evaluate the significance of a deficiency, the last step in your evaluation is to conclude whether a prudent official having knowledge of the same facts and circumstances, would agree with your classification of the deficiency. Although the term *prudent official* is not defined in the standard, the concept is that an auditor should "stand back" and take another objective look at the severity of the deficiency much as would a regulator or someone from an oversight agency. You are being asked to consider whether a *prudent official* (knowing what you know about the facts and circumstances, the likelihood and magnitude of the potential misstatement, and the other controls that you tested) would agree with your conclusion that a deficiency is not a significant deficiency or that a significant deficiency is not a material weakness. Would you be comfortable defending your conclusion? If not, you should reconsider your evaluation of the significance of the deficiency looking through the skeptical lens of a prudent official. Because a prudent official is cautious, the prudent official test is used only to increase the severity of a control deficiency and not to justify a decrease in the severity.

.25 SAS No. 112 includes (1) a list of areas in which control deficiencies ordinarily are at least significant deficiencies, and (2) a list of indicators that a control deficiency should be regarded as at least a significant deficiency and a strong indicator of a material weakness. A material financial statement misstatement that was not identified by management is a strong indicator of a material weakness.

.26 SAS No. 112 also contains an Appendix [AU section 325.32] that provides examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses. This Appendix [AU section 325.32] revises and expands on the examples contained in the Appendix to SAS No. 60. The following are some of the items included in the Appendix [AU section 325.32]:

- Inadequate design of internal control over the preparation of the financial statements being audited
- Employees or management who lack the qualifications and training to fulfill their assigned functions; for example, the corporate controller lacks the knowledge and skill to apply GAAP in recording the entity's financial transactions or preparing its financial statements
- Inadequate design of information technology (IT) general and application controls
- Inadequate documentation of the components of internal control
- Inadequate design of monitoring controls that assess the design and operating effectiveness of the entity's internal control over time

Communication Requirements

Change From SAS No. 60

Significant deficiencies and material weaknesses must be communicated in writing to management and those charged with governance as part of each audit. This communication includes significant deficiencies and material weaknesses that were communicated to management and those charged with governance that have not yet been remediated.

The communication is best made by the report release date, but should be made no later than 60 days following the report release date.

The illustrative written communications in SAS No. 60 have been revised.

Form of Communication

.27 You must communicate *in writing* to management and those charged with governance.

Content of Communication

.28 You must communicate all control deficiencies that you evaluated as significant deficiencies and material weaknesses. If you communicated significant deficiencies and material weaknesses in previous audits and those deficiencies have not yet been remediated, you must communicate them again. Management and those charged with governance may already know about certain deficiencies and may have made a conscious decision to accept that degree of risk because of cost or other considerations. Management is responsible for that decision. You are responsible for communicating significant deficiencies and material weaknesses, regardless of management's decision. As long as the significant deficiencies and material weaknesses exist, you must continue to communicate them.

.29 You should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

.30 SAS No. 112 contains an illustrative communication that encompasses the requirements of the standard. In addition, SAS No. 112 contains an illustrative communication that may be used when the auditor has been requested to advise management and those charged with governance of the fact that no material weaknesses were identified. Also illustrated is a paragraph to be added to the auditor's communication if, for the benefit of a regulator, management's response to the auditor's communication of significant deficiencies and material weaknesses is included in a document with the auditor's written communication.

Timing of Communication

.31 Best practice is to issue your written communication by the report release date. You should issue your communication no later than 60 days following the report release date.

.32 For some matters, early communication to management or those charged with governance may be important. If you decide to communicate certain identified significant deficiencies and material weaknesses during the audit, the communication may be oral. However, all significant deficiencies and material weaknesses that you communicated orally during the audit must be communicated in writing to management and those charged with governance.

How the Revisions Will Affect Practice

.33 As you gain a better understanding of what needs to be communicated to management and those charged with governance, you may find that there will be more control deficiencies that you:

- Identify as significant deficiencies and material weaknesses, and
- Communicate to management and those charged with governance.

.34 You may emphasize and therefore spend more time evaluating identified control deficiencies than you did in the past.

Discussions With Management and Others

.35 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. You may have to explain to your clients that you, the auditor, *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.36 You may wish or be called upon to hold discussions with management and other users of your written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of *material weaknesses*. Another reason is that you have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in your written communication as long as these deficiencies have not been remediated. You may need to explain to management and other users that you are required to inform them of the significant deficiencies and material weaknesses every year as long as the deficiencies still exist.

.37 You may also need to hold discussions with management and other users who ask how you were able to express a clean opinion on the financial statements when material weaknesses in internal control were present. You may wish to explain that your audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control. You can express a clean opinion on the financial statements even though material weaknesses in internal control are present, because you performed sufficient procedures and obtained appropriate audit evidence to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented or detected by the client.

Issues for Audits of Smaller Entities

.38 One issue that may arise in audits of smaller entities is the possibility of increased costs as a result of the auditor's time spent documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.39 Another issue that may cause concern is the extent to which you (as the auditor) may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if your client has ineffective controls over the preparation of their financial statements such that client controls are absent or controls are not effective in preventing or detecting material misstatements in the preparation of financial statements, including the related footnotes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, since doing so would impair independence.[3] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a control weakness does not change the control weakness.

.40 ***Possible Opportunities.*** The new requirements of SAS No. 112 introduce possible opportunities for you. You can help clients evaluate the cost/benefit implications of improving their internal control, including training their personnel to be more knowledgeable. You can also teach your clients how to develop a risk assessment approach to designing internal control.

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[3] See Ethics Interpretation 101-3, *Performance of Nonattest Services*, under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

Examples

.41 SAS No. 112 includes examples of factors that impact on the consideration of likelihood and magnitude.

Likelihood

.42 The following are examples of factors that may affect the likelihood that a control, or combination of controls, could fail to prevent or detect a misstatement:

- The nature of the financial statement accounts, disclosures, and assertions involved. For example, suspense accounts and related party transactions involve greater risk
- The susceptibility of the related assets or liability to loss or fraud
- The subjectivity and complexity of the amount involved and the extent of judgment necessary to determine that amount
- The cause and frequency of any known or detected exceptions relating to the operating effectiveness of a control
- The interaction or relationship of the control with other controls
- The interaction of the control deficiency with other control deficiencies
- The possible future consequences of the deficiency

Magnitude

.43 Factors that may affect the magnitude of a misstatement that could result in a deficiency or deficiencies in controls include but are not limited to the following:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity in the account balance or class of transactions exposed to the deficiency in the current period or expected in future periods

.44 Generally, the recorded amount is the maximum amount by which an account balance or total of transactions can be overstated. However, because of the potential for unrecorded amounts, there is no upper limit on the amount of potential understatement. For example, if there is a control deficiency over the completeness of accounts payable, and the recorded amount is $200,000, the most the amount could be overstated is $200,000. But the most the amount could be understated cannot be known.

.45 The following are examples of control deficiencies and how their likelihood and magnitude might be considered:

- *Failure to obtain required authorization for a valid disbursement*. In this case, you may consider the likelihood of misstatement that could result from recording an unauthorized disbursement, using the factors listed above.
- *A deficiency in controls over revenue transactions that results in a financial statement misstatement*. In this case, the likelihood of misstatement is more than remote because a misstatement actually occurred. You may consider the potential for misstatement in amounts greater than the identified misstatement.

Control Deficiencies, Significant Deficiencies, or Material Weaknesses

.46 The following paragraphs describe circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

.47 Deficiencies in the design of controls may include the following:

- Inadequate design of internal control over the preparation of the financial statements being audited
- Inadequate design of internal control over a significant account or process
- Inadequate documentation of the components of internal control
- Insufficient control consciousness within the organization, for example, the tone at the top and the control environment
- Absent or inadequate segregation of duties within a significant account or process
- Absent or inadequate controls over the safeguarding of assets (This applies to controls that the auditor determines would be necessary for effective internal control over financial reporting.)
- Inadequate design of information technology (IT) general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs
- Employees or management who lack the qualifications and training to fulfill their assigned functions (For example, in an entity that prepares financial statements in accordance with GAAP, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording the entity's financial transactions or preparing its financial statements.)
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time
- The absence of an internal process to report deficiencies in internal control to management on a timely basis

.48 Failures in the operation of internal control may include the following:

- Failure in the operation of effectively designed controls over a significant account or process; for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy; for example, the failure to obtain timely and accurately consolidating information from remote locations that is needed to prepare the financial statements
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation
- Failure to perform reconciliations of significant accounts; for example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner
- Undue bias or lack of objectivity by those responsible for accounting decisions; for example, consistent understatement of expenses or overstatement of allowances at the direction of management
- Misrepresentation by client personnel to the auditor (an indicator of fraud)

- Management override of controls
- Failure of an application control caused by a deficiency in the design or operation of an IT general control

.49 Note that the third circumstance in the preceding list, failure of controls designed to safeguard assets from loss, damage, or misappropriation, may need careful consideration before it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, given that the definitions of material weakness and significant deficiency relate to the likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

Significant Deficiencies

.50 Deficiencies in the following areas ordinarily are at least significant deficiencies in internal control:

- Controls over the selection and application of accounting principles that are in conformity with GAAP; having sufficient expertise in selecting and applying accounting principles is an aspect of such controls
- Antifraud programs and controls
- Controls over nonroutine and nonsystematic transactions
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements.

Material Weaknesses

.51 Each of the following circumstances is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- Ineffective oversight by those charged with governance of the entity's financial reporting and internal control, or an ineffective overall governance structure
- Restatement of previously issued financial statements to reflect the correction of a material misstatement (The correction of a misstatement includes misstatements due to error or fraud but not restatements to reflect a change in accounting principle to comply with a new accounting principle or a voluntary change from one GAAP to another.)
- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the entity's internal control (This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amounts, which is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)

- An ineffective internal audit function or risk assessment function at an entity for which such functions are important to the monitoring or risk assessment component of internal control, such as for very large or highly complex entities
- For complex entities in highly regulated industries, an ineffective regulatory compliance function (This relates solely to those aspects of the ineffective regulatory compliance function for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting. When evaluating the severity of such control deficiencies, the auditor should consider whether the entity has controls in place to monitor the impact on the financial statements of laws and regulations relevant to the conduct of the entity's business, and should evaluate the severity of the absence of such controls based on the entity's potential to misstate obligations that may arise from such laws or regulations.)
- Identification of fraud of any magnitude on the part of senior management (The auditor has a responsibility to plan and perform procedures to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by error or fraud.[4] However, for the purposes of evaluating and communicating deficiencies in internal control, the auditor should evaluate fraud of any magnitude—including fraud resulting in immaterial misstatements—on the part of senior management, of which he or she is aware.)
- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected (See paragraph .23 of SAS No. 112 for communication requirements in these circumstances.)
- An ineffective control environment (Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment.)

Evaluation Questions

.52 In evaluating the severity of a control deficiency, the first step is to determine whether the deficiency is at least a significant deficiency. Some questions to ask yourself when making this determination include:

- Is the likelihood that a misstatement of any magnitude could occur and not be detected by the client's controls considered remote?
- Is the magnitude of a potential misstatement inconsequential or less than inconsequential to the financial statements? A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements.
- Are there complementary or redundant controls that were tested and evaluated that achieve the same control objective?
- Are there compensating controls that were tested and evaluated that limit the magnitude of a misstatement of the financial statements to inconsequential?

.53 If the answers to these questions are all *no*, then the deficiency is at least a significant deficiency. If the answer to any question is *yes*, before concluding that the control deficiency is *not* at least a significant deficiency ask yourself: Would prudent officials, having my knowledge of the facts and circumstances, agree with my conclusion that the deficiency is *not* at least a significant deficiency?

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[4] AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), provides guidance on the auditor's responsibilities for planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether caused by error or fraud.

.54 If a prudent official would consider the control deficiency to be at least a significant deficiency, then you would conclude that the deficiency is at least a significant deficiency.

.55 The next step is to assess whether the deficiency is a material weakness. Some questions to ask yourself in making this determination include:

- Is the magnitude of the potential misstatement less than material to the financial statements?
- Are there compensating controls that were tested and evaluated that limit the magnitude of a misstatement of the financial statements to less than material but more than inconsequential?
- Does additional evaluation result in a judgment that the likelihood of a material misstatement of the financial statements is remote?

.56 If the answers to these questions are all *no*, then the deficiency is a material weakness. If the answer to any question is *yes*, before concluding that the deficiency is *not* a material weakness, ask yourself, Would prudent officials, having my knowledge of the facts and circumstances, agree with my conclusion that the deficiency is a significant deficiency and not a material weakness, considering the financial statements?

.57 If a prudent official would consider the control deficiency to be a material weakness, then you would conclude that the deficiency is a material weakness.

Case Studies

.58 This section contains case studies that each highlight a particular control deficiency. Each case study contains a description of the control deficiencies, and an analysis of the assessment of the severity of the control deficiency. The control deficiencies discussed are:

- Lack of segregation of duties
- Lack of client expertise in financial accounting and reporting
- Inventory-related control deficiencies
- Failure to review modifications of standard sales contracts to evaluate their effect on the timing and amount of revenue recognition
- Fraud involving cash
- Control testing exceptions

Control Deficiency 1: Lack of Segregation of Duties

Situation 1

.59 Your client is a small nonprofit organization that has only one person in charge of the accounting and reporting functions. Through your understanding of controls over cash disbursements, you observe a lack of segregation of duties, which is a control deficiency. In assessing the severity of the control deficiency, you consider whether there are complementary, redundant, or compensating controls.

.60 ***Additional Facts.*** Through obtaining your understanding of internal control, you've learned that a board member signs all checks, reviewing invoices that support the disbursement before signing. The signed checks are returned to the client to be mailed. The bank sends the bank statement directly to the board member, who reviews the bank statement and returned checks. The bank statement is then given to the client for reconciliation.

.61 ***Discussion.*** Your assessment of the severity of this control deficiency would be based on the effectiveness of the compensating controls performed by the board members. The compensating controls do not eliminate the deficiency but may mitigate the effects of the control deficiency.

.62 If the board member does not perform a review of the bank statement and the returned checks, verifying that all the checks have the appropriate signature and that the check payee and amount have not been altered, you might determine that the compensating control over disbursements is not effective in achieving the control objective and, therefore, there is a material weakness.

.63 If the board member reviews only returned checks over a certain dollar amount, you might conclude that the compensating control is effective in preventing or detecting a material misstatement of cash and, therefore, this may be considered a significant deficiency because the magnitude of the reasonably possible misstatement is less than material but more than inconsequential.

.64 However, if the board member examines the returned checks for the appropriate signature and alterations, you might conclude that the compensating control is effective in preventing or detecting an unauthorized disbursement, making the likelihood of a misstatement remote; therefore, this is only a control deficiency and not a significant deficiency or material weakness.

Situation 2

.65 Your client is a small business that has only one person in charge of the accounting and reporting functions. The bookkeeper has been with the company for many years. It is common for the owner to leave signed, blank checks with the bookkeeper, "in case of emergencies" when the owner is gone. The owner does not perform any oversight procedures. The owner has you, the auditor, perform quarterly interim procedures. The owner believes the auditors are a substitute for his lack of oversight. One of the auditor's quarterly procedures is to review the bank reconciliation, which is prepared by the bookkeeper.

.66 ***Discussion.*** Because the auditor cannot be part of the client's internal control, your interim procedures, including your review of the bank reconciliations, are not compensating controls. Should the bookkeeper betray the owner's trust, the magnitude of a potential misstatement could reasonably be expected to be material. In your judgment, you believe that a reasonable person would conclude that there is more than a remote possibility that a misstatement could occur and not be caught by the owner. Thus, the lack of segregation of duties and the lack of oversight would be considered material weaknesses.

Control Deficiency 2: Lack of Client Expertise in Financial Accounting and Reporting

.67 In situations 3, 4, and 5, you provide assistance to your client in the drafting of the financial statements but, as the auditor, remain independent under Ethics Interpretation 101-3, *Performance of Nonattest Services*, under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05). That is, you post client-approved adjusting entries to the trial balance and assist in the drafting of the financial statements from the trial balance. You are not responsible for preparing and approving adjusting entries.

Situation 3

.68 Your client's controller is fairly skilled and is able to perform most of the functions necessary to prepare the financial statements. However, the company does not maintain a fixed asset ledger. Rather, you maintain a fixed asset ledger for them on your computer using "off-the-shelf" fixed asset software. From this software package, you are able to print for the controller a projected depreciation schedule, a gain and loss calculation report based on cost, and sales information provided to you by the controller and a final depreciation and fixed asset listing at year-end. The controller provides adequate supervision of the depreciation calculation so there is no conflict with Interpretation 101-3. The book and tax depreciation calculation affects depreciation expense for book purposes and also the calculation of deferred taxes. The client could purchase a depreciation program but has concluded it is more cost effective to rely on you for these records.

.69 In most years, the controller provides you with a year-end adjustment if adjustments hadn't already been made to the general ledger. However, in this particular year, the controller has been preoccupied with other tasks and asks you to calculate the year-end depreciation adjustment and gain or loss on sale adjustment. The adjustment is a material adjustment. Because you propose the adjustment, you need to consider whether there is a control deficiency.

.70 ***Discussion.*** In this situation, you would begin by considering the likelihood that a misstatement would not be detected. Because the auditor cannot be part of a client's internal controls, the controls that exist in your CPA firm to perform the calculations cannot be taken into account in considering whether the client has a control deficiency. Instead, you must consider what controls the client has to detect a misstatement. Based on only these facts, your judgment is that the client has the competency to perform the accounting function but has chosen to outsource the depreciation closing function this year. Therefore, as long as the client is reviewing and taking responsibility for the depreciation and related calculations, and possesses the skills and competencies to prevent, detect, and correct potential misstatements, you would determine that there is not a control deficiency. If the client is not able to prevent, detect, and correct a misstatement, then you would determine that there is a control deficiency.

Situation 4

.71 This client has an accounting manager who requests that you assist in drafting the financial statements and notes to the financial statements. However, prior to signing the representation letter, the accounting manager obtains the financial statement grouping schedules and the schedules documenting the calculation of amounts included in the notes to the financial statements, and reviews and approves these schedules. In addition, the accounting manager obtains a current disclosure checklist from the AICPA and reviews and answers the checklist to ensure propriety and completeness of the footnotes. The financial statements are also read, revised, and approved by both the accounting manager and the owner.

.72 ***Discussion.*** Based only on the facts presented, there is not an observed control deficiency. You would need to further understand whether the client's controls are designed appropriately and operating effectively, and that would be dependent on the competence and expertise of the client's accounting manager. In assessing this situation, you would first consider the likelihood of a material misstatement in the presentation and disclosure of the financial statements, including the related footnotes, occurring and not being detected by the accounting manager. If you determine that the accounting manager and owner lack the necessary accounting expertise to detect a misstatement, then that would represent a control deficiency that would need to be evaluated. However, you might conclude that, despite the accounting manager asking you to assist in drafting the financial statements and footnotes, they (the accounting manger and owner) do possess the necessary accounting expertise to prevent, detect, and correct a potential misstatement in the financial statements or notes; therefore, you would not have a control deficiency.

Situation 5

.73 At this client, you taught the bookkeeper to record cash receipts and disbursements as well as the adjusting journal entries needed to record accounts receivable and payable at year-end. The bookkeeper follows your directions and prepares a draft of the year-end financial statements from a format you provided, including relevant recurring disclosures.

.74 During your audit, you notice that the owner acquired a new delivery truck that cost $50,000—an amount that is material to the company's financial statements—and financed the acquisition through the dealer's finance company. You determine that the financing lease should be capitalized. The bookkeeper has recorded the monthly cash payments for the truck to the dealership but has not recorded the initial fixed asset and related liability (the owner had told her that he was leasing the truck). In discussing the new truck with the bookkeeper, you further discover that the owner was involved in a collision on the last day of the year while driving the truck and the company's insurance covered only a small portion of the damages. The financial statements do not reflect the capital lease and the related liability, nor does it reflect the expense and liability for the damages in excess of the company's insurance.

.75 ***Discussion.*** Based only on these facts, you determine that there is a control deficiency that did not detect, prevent, or correct the misstatements in the client's drafted financial statements. Because you caught this error, your judgment is that the likelihood that the financial statements would be misstated is more than remote, and the magnitude of the misstatement is material. You are not an employee of the company and cannot be part of the company's internal control. The company did not have anyone on staff with sufficient expertise to properly analyze the lease and record the fixed asset acquisition, and the bookkeeper was not sufficiently knowledgeable to know that she needed help in recording these events. In this case, the quality of the financial statements was not a result of the company's internal control. As such, you determine that the entity has a material weakness.

.76 If the bookkeeper had called you for guidance about how to account for these events, before recording them, your conclusion most likely would have been different. A discussion with the client about a technical issue is not, in and of itself, an indication of a weakness in the company's internal control. The client's ability to detect a potential misstatement, and ability to gain the necessary competence, are factors you would consider in your understanding of the entity's internal control.

Control Deficiency 3: Inventory-Related Control Deficiencies

Situation 6

.77 Your client is a large car dealership. There is a lack of good controls over tracking inventory quantities of dealership parts, but a physical inventory is taken at the end of every quarter. A parts manager was selling dealership parts, not recording the sales, and keeping the receipts. Although the amount of the writedown needed to reflect actual inventory was not material to the financial statements, management became aware of the fraud when the parts manager confessed under questioning.

.78 ***Discussion.*** The purpose of your evaluation is to assess the likelihood and potential magnitude of a financial statement misstatement, not the likelihood and potential magnitude of a loss due to fraud. Because the preventive controls tracking inventory quantities are weak, the client is relying on detective controls—physical inventory—to catch any potential misstatement. From a design perspective, detective controls are seldom as effective as preventive controls, as evidenced by the fact that the client suffered a loss as a result of the weak preventive controls. However, the physical inventory was effective at detecting the loss, so that the financial statements were not materially misstated. Because you would consider the effect of compensating controls in your assessment of the severity of the control deficiency, you would conclude that the preventive control weakness is mitigated by the detection control to the extent that there is not a significant deficiency or material weakness in internal control over financial reporting.

.79 Although the fraud did not result in a *material* misstatement of the financial statements, the fraud is evidence of a control deficiency in internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition. AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), requires that 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. Therefore, you may wish to include this misappropriation (and other risks of fraud that you have identified) in your written communication of significant deficiencies and material weaknesses.

Control Deficiency 4: Failure to Review Modifications of Standard Sales Contracts to Evaluate Their Effect on the Timing and Amount of Revenue Recognition

Situation 7

.80 Your client uses a standard sales contract for most transactions. Individual sales transactions are not material. Sales personnel are permitted to modify the terms of the sales contract, including shipping terms. Accounting personnel review the terms of the sales contracts for significant or unusual modifications but do not review changes in the standard shipping terms. The changes in the standard shipping terms could cause a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. There have been a limited number of instances in which revenue was inappropriately recorded, but the related amounts have not been material.

.81 ***Discussion.*** Based on only these facts, you determine that a control deficiency exists in the design of the entity's controls because there are no controls over a sales person's ability to modify the standard sales contract. In evaluating the severity of this control deficiency, you consider the likelihood and potential magnitude of a financial statement misstatement resulting from this deficiency. The magnitude could reasonably be expected to be more than inconsequential. However, the magnitude would be expected to be less than material, because individual sales transactions are not material and the compensating controls that mitigate the deficiency, which operate monthly and at the end of each financial reporting period, increase the likelihood that a material misstatement will be detected. Furthermore, the risk of material misstatement is limited to revenue recognition errors related to shipping terms, as opposed to broader sources of error in revenue recognition. However, the compensating controls are designed to detect only material misstatements. The controls do not effectively address the detection of misstatements that are more than inconsequential but less than material, as evidenced by situations in which transactions that were not material were improperly recorded. Therefore, there is a more than remote likelihood that a misstatement that is more than inconsequential but less than material could occur. Based on only these facts, you would conclude that this deficiency is a significant deficiency.

Situation 8

.82 Your client has a standard sales contract, but sales personnel frequently modify the terms of the contract. Certain modifications can affect the timing and amount of revenue recognized. Individual sales transactions frequently are material to the entity, and the gross margin can vary significantly for each transaction.

.83 Through your understanding of internal control necessary to plan the audit, you determine that the entity has a design deficiency in that the entity does not have procedures in place for accounting personnel to regularly review modifications to the terms of sales contracts. Although management reviews gross margins on a monthly basis, the significant differences in gross margins for individual transactions make it difficult for management to identify potential misstatements. Improper revenue recognition has occurred in the past, and the amounts have been material.

.84 ***Discussion.*** The magnitude of a financial statement misstatement resulting from this control deficiency would reasonably be expected to be material because individual sales transactions are frequently material, and gross margin can vary significantly with each transaction (which would make compensating controls based on a reasonableness review ineffective). Additionally, improper revenue recognition has occurred, and the amounts have been material. Therefore, the likelihood of material misstatements occurring is more than remote. Because, taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency is material, you determine that this deficiency is a material weakness.

Situation 9

.85 The entity has a standard sales contract; however, sales personnel frequently modify the terms of the contract. Sales personnel frequently grant unauthorized and unrecorded sales discounts to customers without the knowledge of the accounting department. These discounts are taken by customers, deducted from the amount paid, and recorded as outstanding balances in the accounts receivable aging. Although the amounts of these discounts are individually insignificant, they are material in the aggregate and have occurred consistently during the past few years.

.86 ***Discussion.*** The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because the frequency of occurrence allows insignificant amounts to become material in the aggregate. The likelihood of a material misstatement of the financial statements resulting from this internal control deficiency is more than remote (even if the client fully reserved for the uncollectible accounts) due to the likelihood of material misstatement of the gross accounts receivable balance. Therefore, your judgment is that this deficiency represents a material weakness.

Control Deficiency 5: Fraud Involving Cash

Situation 10

.87 Your client is a small not-for-profit organization that receives most donations by check from corporate donors. Some donations are made in cash. Cash donations are not material to the financial statements. As a result of your understanding of internal control, you notice that there are no controls over cash receipts. In planning your audit, you identify this as a fraud risk and you perform additional auditing procedures relative to cash receipts. Through inquiry, you learn that someone may be stealing cash. You notify management and as a result of performing certain audit tests you discover evidence that indicates that an employee was pocketing the cash and that cash donations were not being recorded.

.88 ***Discussion.*** Your judgment is that the likelihood of a misstatement is more than remote, as the fraud has occurred. The magnitude of the potential financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential but less than material, as total cash sales are less than material. Thus, this deficiency is at least a significant deficiency. However, because your client is a not-for-profit organization, because cash is a sensitive area, and because fraud is involved, you step back and try to look at this situation from a prudent official's perspective. You consider how a regulator may view this, how a donor may view this, and how others in the nonprofit community may view this. In doing that, your judgment is that a prudent official would probably view an absence of controls over cash receipts as a material weakness. Therefore, you conclude that this is a material weakness.

Control Deficiency 6: Control Testing Exceptions

Situation 11

.89 In performing tests of controls during the audit, you identify an exception. You determined that the exception was one of numerous internal control exceptions that occurred during the two weeks that the controller was on vacation. Controls operated effectively before he left and after he returned to work. No misstatements in the financial statements were identified relating to that period of time.

.90 *Discussion.* You first need to determine whether the control testing exception is a control deficiency before considering the severity of that control deficiency. Effective internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting. Because effective internal control over financial reporting cannot and does not provide absolute assurance of achieving financial reporting objectives, any individual control does not necessarily have to operate perfectly, all the time, to be considered effective. You may want to gather additional evidence, beyond what you had initially planned and beyond inquiry, to support your conclusion that the exception does not represent a control deficiency. You cannot use the lack of actual misstatements to lessen the severity of the control deficiency in your determination, because you have to consider *potential* misstatements of any magnitude. Factors to consider in making your determination would include complementary, redundant, or compensating controls, which could include the monitoring activities undertaken by the controller upon returning from vacation.

Resource Central

Publications

.91 The following publications deliver valuable guidance and practical assistance related to internal control:

- *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk) (expected to be available in December 2006), a cornerstone AICPA Audit Guide encompassing and updating the existing AICPA Audit Guide, *Consideration of Internal Control in a Financial Statement Audit*, and encompassing the new "Risk Assessment" Standards (SASs No. 104–No. 111). This Guide illustrates how to gather the information needed to assess risk, evaluate that information to assess risks at the assertion level, and design and perform further audit procedures based on those assessed risks, evaluate the results, and reach conclusions.
- *Internal Control—Integrated Framework* (product no. 990012kk), a paperbound version of the COSO report that established a common definition of internal control different parties can use to assess and improve their control systems. It also includes information on how to prepare external reports and five tools for evaluating each of the components identified in the framework.
- *Financial Reporting Fraud: A Practical Guide to Detection and Internal Control* (product no. 029879kk), a paperbound publication for CPAs in both public practice and industry. It uses case studies to provide information necessary to minimize fraud exposure for CPAs, employers, and clients.
- *Audit Committee Toolkit* (product no. 991001kk), a practice aid that brings you checklists, matrixes, questionnaires, and other materials that are designed to help the audit committee do the job it needs to do.

Guidance for Audit Committees on the Risk of Fraud From Management Override of Internal Control

.92 The AICPA Antifraud Programs and Controls Task Force has issued a document entitled *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention—The Audit Committee and Oversight of Financial Reporting*. The document offers assistance to audit committees in addressing the risk of fraud arising from management override of internal control over financial reporting. The guidance contains the following major sections:

- "Management Override and the Audit Committee's Responsibilities"
- "Actions to Address the Risk of Management Override of Internal Controls"
- "Suggested Audit Committee Procedures: Strengthening Knowledge of the Business and Related Financial Statement Risks" (Appendix)

.93 The following are some of the topics related to audit committees that are covered in the document:

- Maintaining an appropriate level of skepticism
- Strengthening the audit committee's understanding of the business
- Brainstorming to identify fraud risks
- Using the code of conduct to assess financial reporting culture
- Cultivating a vigorous whistle-blower program
- Developing a broad information and feedback network including communications with internal auditors, independent auditors, compensation committee, and key employees

.94 The document can be downloaded from the "Spotlight Area" on the AICPA's Audit Committee Effectiveness Center Web page at www.aicpa.org/audcommctr/homepage.htm.

AICPA's reSOURCE Online Accounting and Auditing Literature

.95 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.

reSOURCE CD-ROM

.96 The AICPA offers 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 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 and Training

.97 Among its numerous continuing professional education (CPE) courses about internal control, the AICPA offers the following products. Information about additional AICPA internal control-related CPE courses can be obtained at www.cpa2biz.com:

- *Internal Control and IT: Reliable Reporting and Fraud Prevention*, a CPE course that provides an overview of the key auditing standards, conceptual frameworks, IT infrastructures and auditing issues you are likely to face on medium to small company engagements. (product no. 732551kk)
- *Internal Controls: Design and Documentation*, a basic course that explains what makes up an effective system and provides a toolkit of today's current techniques for creating useful documentation. This course will benefit controllers, managers, and internal auditors in businesses as well as auditors and consultants to public and private companies who need a review. (product no. 731852kk)

Online CPE

.98 AICPA *CPExpress*, offered exclusively through CPA2Biz.com, is the AICPA's flagship online learning product with enhancements such as a new user interface and improved functionality. AICPA *CPExpress* 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 *CPExpress* offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com.

AICPA's Antifraud & Corporate Responsibility Resource Center

.99 The AICPA's Antifraud & Corporate Responsibility Resource Center (www.aicpa.org/antifraud/) allows you to select optional ways to learn about fraud. The Center spotlights the new Web-based fraud and ethics case studies and commentaries recently issued; the AICPA antifraud Webcast 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 & Corporate Responsibility Program.

AICPA Audit Committee Effectiveness Center

.100 Located at www.aicpa.org/audcommctr/homepage.htm, the AICPA Audit Committee Effectiveness Center presents the guidance and tools necessary to make audit committee best practices actionable. Available at the center is the AICPA Audit Committee Toolkit, the Audit Committee Matching System, Audit Committee e-Alerts, and other guidance and resources.

AICPA Audit Quality Centers

Governmental Audit Quality Center (GAQC)

.101 The GAQC, which is designed to improve the quality of governmental audits, provides firm members with a set of best practices and tools in the specialized area of governmental auditing, including Yellow Book and Circular A-133 audits. It also includes a comprehensive Web site at www.aicpa.org/GAQC.

Employee Benefit Plan Audit Quality Center

.102 The AICPA Employee Benefit Plan Audit Quality Center is intended to provide a forum that spurs CPA firms performing audits to make immediate quality improvements to employee benefit audits under the Employee Retirement Income Security Act of 1974 (ERISA), including pension, health and welfare, and 401(k) plans. In addition to gaining access to best practices, guidelines, and tools focused around quality improvement, members of the Center are subject to membership requirements that demonstrate the firm's commitment to audit quality in this area. Additional information about the Center can be found at www.aicpa.org/ebpaqc.

Order Department (Service Center Operations)

.103 To order AICPA products, call the AICPA Member 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.

Hotlines

Accounting and Auditing Technical Hotline

.104 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.105 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

.106 AICPA Online (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 and Accounting Guides, the professional standards, CPE courses, practice aids, and alerts.

* * * * *

.107 As you encounter audit or industry issues that you believe warrant discussion in the Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies*, please feel free to share them with us. Any other comments you have about the Alert would be appreciated. Based on comments received, the Alert may be revised in the future. You may e-mail these comments to agoldman@aicpa.org or write to:

Ahava Goldman, CPA
AICPA
1211 Avenue of the Americas
New York, NY 10036

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AAM Section 9000
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. Please 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 9100.

Examples that are assembled from illustrative reporting language set forth in Statements on Auditing Standards (SASs) and Statements on Standards for Accounting and Review Services include citation of the particular source and its location in AICPA *Professional Standards.*

References to Professional Standards. When referring to the professional standards, this manual cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, SAS No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*. All references to AU sections may be found in AICPA *Professional Standards*, volume 1.

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AAM Section 9100

Format of Accountants' Reports

Report Preparation

.01 Firms usually develop standard policies and procedures for preparing and issuing reports. The following are some suggested report preparation policies that the auditor may consider:

- *Letterhead.* The report is typically presented on firm letterhead.
- *Addressee.* The report may be addressed to the board of directors, stockholders, partners, general partners, proprietors, or to the company whose financial statements are being audited. If the firm was engaged by others, the report may be addressed thereto.

  The Board of Directors
  XYZ Credit Union
  City, State Zip Code

- *Salutation.* A salutation is not typically included on the report.
- *Report signing.* The firm name is usually manually signed by the engagement partner. The words "Certified Public Accountants" may be excluded from the signature if they are a normal part of the firm's letterhead.
- *Report dating.* Audit reports should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion.
  - The date is typically presented at the bottom of the page along with the city and state, if it is not included in firm letterhead, as follows:

    City, State
    April 5, 20XX

  - When a subsequent event disclosed in the financial statements occurs after the original date of the auditor's report but before the issuance of the related financial statements, the auditor may use dual dating or date the report as of the later date. 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 typically approves 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. The auditor may wish to consider a step-down in level of service 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 (for example, 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. Following are the four standards of reporting[1] stated in paragraph .02 of AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1):

a. The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).[2]

b. The auditor must identify in the auditor's report those circumstances in which GAAP has not been consistently applied in the current period in relation to the preceding period.

c. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.

d. The auditor must either express an opinion regarding the financial statements taken as a whole or state that an opinion cannot be expressed in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking in the auditor's report.

Standard Report

.03 The standard auditor's report prescribed by AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), may be used when the auditor has formed an opinion, based on the application of GAAS,[3] 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. GAAP). It should state that the financial statements identified in the report were audited. A standard auditor's report for the presentation of comparative financial statements is illustrated in paragraph .01 of AAM section 9210.

Modifications of the Standard Auditor's Report

.04 AU section 508 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 subsequently, are as follows:

- *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 may proceed or follow the opinion paragraph, unless otherwise required by AU section 508.
- *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

[1] The reporting standards apply only when the auditor issues a report.

[2] When an auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles (GAAP), the first standard of reporting is satisfied by stating in the auditor's report that the basis of presentation is a comprehensive basis of accounting other than GAAP and by expressing an opinion (or disclaiming an opinion) on whether the financial statements are presented in conformity with the comprehensive basis of accounting used.

[3] Paragraph .08 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), indicates that one of the basic elements of the standard report is 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 [GAAS]).

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 an explanatory paragraph to be included, preceding the opinion paragraph, that describes the nature of the scope limitation or the departure from GAAP.

- *Disclaimer of opinion.* A disclaimer of opinion may be appropriate 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 may 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. When the auditor expresses an adverse opinion, he or she should disclose in a separate explanatory paragraph, preceding the opinion paragraph, all of the substantive reasons for the adverse opinion and, if practical, 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 audit evidence, 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 may 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.* When financial statements are materially affected by a departure from GAAP, the auditor should express 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 may 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 is described in the notes, the explanatory paragraph may 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. In such situations, the auditor should 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 paragraph .02 of AAM section 9240. An adverse opinion indicating a departure from GAAP is presented in paragraph .01 of AAM section 9220.

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 may 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 may be issued. All such matters could be discussed immediately with the engagement partner.

.11 If a client will not accept modification of the report under the circumstances above, the firm may wish to consider withdrawing from the engagement and consulting with legal counsel.

Consistency Exceptions

.12 Accounting changes affecting consistency include the following:

- 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 (for example, classification of an item in earnings from operations as other income or expense)
- A change in reporting entity

.13 Accounting changes that do not normally affect consistency include the following:

- 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, 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*, and matters related to estimates covered by Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (AICPA, *Technical Practice Aids*, ACC sec. 10,640).

.16 *Uncertainties Not Requiring Modification of the Opinion.* Paragraph .30 of AU section 508 states that when the auditor has concluded that sufficient audit evidence 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.* If the auditor is unable to obtain sufficient audit evidence to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. 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 audit evidence did or does exist, but it is unavailable to him or her (for example, because the information was destroyed or management will not allow the auditor to have access to it), the auditor may consider modifying the report for a scope limitation.

.18 *Departures From GAAP.* Paragraph .45 of AU section 508 describes three categories of departures from GAAP involving risks or uncertainties:

- Inadequate disclosure
- Inappropriate accounting principles
- Unreasonable accounting estimates

.19 If the auditor concludes that a matter involving a risk or uncertainty is not adequately disclosed in the financial statements in conformity with GAAP, the auditor should express a qualified or adverse opinion.

.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 may 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. Paragraphs .12–.13 of AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), 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 has a responsibility to report on all of the information included in the document. 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 may be on the firm's letterhead and should 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 may 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 that 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 may be expressed on the financial statement the auditor was engaged to audit. If the other financial statements are presented, a disclaimer of opinion may be issued on those statements. An unqualified opinion on a single statement audit is presented in paragraph .03 of AAM section 9210.

Relying on the Work of a Specialist

.26 The firm may engage specialists to perform certain work supporting representations in the financial statements. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), 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 appropriate. Findings of the specialist that indicate the financial statements are not in accordance with GAAP may necessitate 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. The Public Company Accounting Oversight Board (PCAOB), through PCAOB Rule 3600T, has provisionally designated Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.01), of the AICPA Code of Professional Conduct, and interpretations and rulings thereunder, as they existed on April 16, 2003, as well as Standard Nos. 1–3 and Interpretations 99-1, 00-1, and 00-2 of the Independence Standards Board as interim independence standards to be followed by registered public accounting firms in connection with the audits of public companies and other issuers. The PCAOB's interim independence rules do not supersede the independence rules of the Securities and Exchange Commission (SEC). Therefore, to the extent that a provision of the SEC's rule or policy is more restrictive—or less restrictive—than the PCAOB's interim independence standards, a registered public accounting firm must comply with the more restrictive requirement. 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 management of the former client and successor auditor. The representation letter from management of the former client should state (*a*) whether any information has come to management's attention that would cause them to believe that any of the previous representations should be modified, and (*b*) whether any events have occurred subsequent to the balance sheet date of the latest prior period financial statements reported on by the predecessor auditor that would require adjustment to or disclosure in those financial statements.[4] The successor should represent that his or her audit has not revealed any matters that may have a material effect on the prior period financial statements.

.31 If the firm reissues its report without change, the previous report date should be used. If the financial statements or the report of the prior period are revised, the report should be dual dated as to the event or matter causing the revision. There should be no reference to the report or the work of the successor auditor.

Reissuance of the Audit Report Subsequent to the Date of Original Issue[5]

.32 Occasionally the firm may be requested by a client to furnish additional copies of a previously issued report. Approval of the engagement partner may be 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.

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[*] The Public Company Accounting Oversight Board (PCAOB) also adopted a new rule related to the auditor's responsibilities when seeking audit committee preapproval of internal control related nonaudit services. The rule is intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-relates services may affect independence. Specifically, the public accounting firm shall describe, in writing, the scope of the service and submit to the audit committee, as well as discuss with the audit committee the potential effects of the service on the firm's independence. Public firms are also required to document the substance of such discussions in writing. This rule is effective for audits of fiscal years ending on or after November 15, 2007 (the same effective date as Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* [AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"]). The full text of this rule can be found at www.pcaob.org/Rules/Rules_of_the_Board/Rule_3525.pdf.

[4] See appendix C, "Illustrative Updating Management Representation Letter," paragraph .18 of AU section 333, *Management Representations* (AICPA, *Professional Standards*, vol. 1).

[5] The AICPA Auditing Standards Board Auditing Interpretation, "Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report," of AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 9341 par. .01–.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.

.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 may 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 auditor 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 may be made in one of the following ways:

- 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 in the preceding paragraph, the auditor may wish to contact legal counsel. He or she should also notify all members of the board of directors of such refusal. 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 paragraph .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, the auditor can merely indicate that information has come to his or her attention that his or her client has not cooperated in attempting to substantiate, and that, if the information is true, the auditor believes that his or her report must no longer be relied upon nor should the auditor be associated with the financial statements.

[*The next page is 9211.*]

AAM Section 9210

Unqualified Opinions

.01 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: AU section 508 paragraph .08, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1)]

.02 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: AU section 508 paragraph .08]

.03 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: AU section 508 paragraph .34]

Note: If reporting on a single statement (for example, balance sheet only) when other financial statements are also presented, the following paragraph may 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.

.04 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.

[*Same second paragraph as the standard report*]

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.

[*If the predecessor auditor's report was other than a standard report, the successor auditor should describe the nature of and reasons for the explanatory paragraph added to the predecessor's report or the opinion qualification. Following is an illustration of the wording that may be included in the successor auditor's report*:]

...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.

[*If the financial statements have been restated, the introductory paragraph should indicate that a predecessor auditor reported on the financial statements of the prior period before restatement. In addition, if the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, he or she may also include the following paragraph in his report*:]

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: AU section 508 paragraph .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: AU section 508 paragraph .74, footnote 29]

.05 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: AU section 508 paragraph .13]

.06 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: AU section 508 paragraph .74]

.07 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.[1]

[*Signature*]

[*Date*]

[Source: AU section 508 paragraph .74]

[1] 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.

.08 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: AU section 543 paragraph .16, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1)]

Note: This report is used when the auditor concludes that he or she cannot serve as principal auditor for the restated financial statements.

.09 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, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

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: Interpretation No. 15, "Reporting as Successor Auditor When Prior-Period Audited Financial Statement Were Audited by a Predecessor Auditor Who Has Ceased Operations" of AU section 508 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .61)]

.10 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, and for the year then ended, before the restatement described in Note X, were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

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.[2]

[*Signature*]

[*Date*]

[Source: AU section 508 paragraph .74 and Auditing Interpretation No. 15 of AU section 508 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .62–.63)]

[2] 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.

.11 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*]

[Source: AU section 508 paragraph .74]

.12 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*]

[Source: AU section 508 paragraph .74]

.13 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: AU section 508 paragraph .17]

.14 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: AU section 341 paragraph .13, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1)]

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.

.15 Liquidation Basis of Accounting—Single Year Financial Statements

Independent Auditor's Report

Addressee:

We have audited the statement of net assets in liquidation of XYZ 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 XYZ 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 XYZ 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 preceding paragraph.

[*Signature*]

[*Date*]

[Source: Interpretation No. 8, "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting" of AU section 508 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .36)]

.16 Liquidation Basis of Accounting—Comparative Financial Statements

Independent Auditor's Report

Addressee:

We have audited the balance sheet of XYZ Company as of December 31, 20X1, 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 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.

As described in Note X to the financial statements, the stockholders of XYZ 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 XYZ Company as of December 31, 20X1, 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 preceding paragraph.

[*Signature*]

[*Date*]

[Source: Auditing Interpretation No. 8, paragraph .36 of AU section 508]

.17 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: AU section 508 paragraph .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.

.18 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: AU section 508 paragraph .69]

.19 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: AU section 504 paragraph .17, *Association With Financial Statements* (AICPA, *Professional Standards*, vol. 1)]

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 paragraph .21.)

.20 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: AU section 504 paragraph .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.

.21 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*]

[Source: AU section 504 paragraph .17]

Notes: The above report illustrates a disclaimer of opinion as described in AU section 504 paragraph .17 when the financial statements are those of a public entity. For a nonpublic entity, see paragraphs .19 and .20.

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.

.22 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 generally 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 [*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*]

[Source: AU section 534 paragraph .10, *Reporting on Financial Statements Prepared for Use in Other Countries* (AICPA, *Professional Standards*, vol. 1)]

.23 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 AU section 534 paragraphs .14–.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.

.24 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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.

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: AU section 508 paragraph .08 and AU section 420 paragraph .12, *Consistency of Application of Generally Accepted Accounting Principles* (AICPA, *Professional Standards*, vol. 1), 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 (AU section 561 paragraph .06*b*, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* [AICPA, *Professional Standards*, vol. 1]).

.25 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 misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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.

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 percent of the Company's total assets and X percent of its revenues.

[*Signature*]

[*Date*]

[Source: AU section 508 paragraphs .08–.19]

.26 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 misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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.

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: AU section 561 paragraph .06*a* and AU section 508 paragraph .08, respectively]

.27 Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of XYZ Company as of December 31, 20X4, and the related statements of income and 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.* An audit also 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, 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 XYZ Company as of December 31, 20X4, 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: AU section 9508 paragraphs .85–.88]

Note: The additional language related to internal control should not be used when reporting on the audit of financial statements of a nonissuer that engages its auditor to examine (or audit) and report on the effectiveness of internal control over financial reporting either voluntarily or to comply with regulatory requirements.

.28 Reference to PCAOB Standards in an Audit Report on a Nonissuer

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of XYZ Company as of December 31, 20X4, and the related statements of income and retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with *generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (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 Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting.Accordingly we express no such opinion.* An audit also 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, 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 XYZ Company as of December 31, 20X4, 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: AU section 9508 paragraphs .89–.92]

Note: This example includes the illustrative language from AU section 9508 paragraph .88. Because the PCAOB's Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting that is Integrated With An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), requires an audit of internal control for those entities that are subject to Section 404(a) of the act, an audit of a nonissuer performed under PCAOB auditing standards does not require an audit of internal control unless otherwise required by a regulator with jurisdiction over the nonissuer. The additional language related to internal control should not be used when reporting on the audit of financial statements of a nonissuer that engages its auditor to examine (or audit) and report on the effectiveness of internal control over financial reporting either voluntarily or to comply with regulatory requirements.

[*The next page is 9271.*]

AAM Section 9220

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 in 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: AU section 508 paragraph .60, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1)]

[*The next page is 9321.*]

AAM Section 9230

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.[1]

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: AU section 508 paragraph .26]

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[1] 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, AU section 508 paragraph .67, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), 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.[2]

[*Second paragraph of standard report should be omitted*]

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: AU section 508 paragraph .63]

[2] The wording in the first paragraph of the auditor's standard report is changed in a disclaimer of opinion because of a scope limitation. The first sentence now states that "we were engaged to audit" rather than "we have audited" since, because of the scope limitation, the auditor was not able to perform an audit in accordance with generally accepted auditing standards. In addition, the last sentence of the first paragraph is also deleted, because of the scope limitation, to eliminate the reference to the auditor's responsibility to express an opinion.

.03 Scope Limitation—Inventory and Generally Accepted Accounting Principles 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: AU section 508 paragraphs .39 and .63]

Note: This report would be used if the generally accepted accounting principles departure is not so material to require an adverse opinion. See paragraph .01 of AAM section 9220 for an example of an adverse opinion.

[*The next page is 9371.*]

AAM Section 9240

Qualified Opinions

.01 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: AU section 508 paragraph .26, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1)]

.02 Departure From GAAP—Leases Not Capitalized—Role

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: AU section 508 paragraph .39]

.03 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: AU section 508 paragraph .40]

.04 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: AU section 508 paragraph .42]

Note: This report assumes the effects are such that the auditor has concluded an adverse opinion is not appropriate.

.05 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: AU section 508 paragraph .44]

.06 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: AU section 508 paragraph .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 AU section 508 paragraph .16–.18, an explanatory paragraph is not required in this instance.

.07 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: AU section 508 paragraph .55]

.08 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: AU section 508 paragraphs .26 and .39]

[*The next page is 9421.*]

AAM Section 9245

Information Accompanying Audited Financial Statements

.01 Omission of Supplementary Information Required by the Financial Accounting Standards Board

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 generally accepted accounting principles (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: AU section 558 paragraph .08, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1)]

[1] The auditor may identify the body requiring the information, such as the Financial Accounting Standards Board (FASB) in this example.

.02 Omission of Supplementary Information Required by the Governmental Accounting Standards Board

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements 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 opinions 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. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion.*][2] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof 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*[3]] that accounting principles generally accepted in the United States of America require to supplement, although not to be part of, the basic financial statements.

[*Signature*]

[*Date*]

[Sources: AU section 558 paragraph .08; AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2008, paragraph 14.56]

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[2] This optional wording may be added in accordance with Auditing Interpretation No. 17 "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards" of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88), which provides reporting guidance for audits of nonissuers. If this optional wording is added, the remainder of the paragraph should read as follows:

> "An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions."

[3] The auditor may identify the body requiring the information, such as the Governmental Accounting Standards Board (GASB) in this example.

.03 Material Departures From FASB Guidelines for Required 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 GAAP*[4] *guidelines*].

[*Signature*]

[*Date*]

[Source: AU section 558 paragraph .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: AU section 558 paragraph .11] (See paragraph .10.)

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[4] The auditor may identify the body requiring the information, such as the FASB in this example.

.04 Material Departures From GASB Guidelines for Required Supplementary Information

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements 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 opinions 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. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion.*][5] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof 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 pages XX through XX and XX through XX are 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 GAAP*[6]].

[*Signature*]

[*Date*]

[Sources: AU section 558 paragraph .08; AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2008, paragraph 14.79 (appendix A, example A-1)]

Note: GASB standards require the management's discussion and analysis, which is required supplementary information (RSI), to precede the basic financial statements and most other RSI to be presented immediately following the notes to the financial statements. Although paragraph .11 of AU section 558 discusses alternative placement of RSI provided it is clearly marked as unaudited, that alternative is not available for GASB-required supplementary information given the GASB's specific

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[5] This optional wording may be added in accordance with Auditing Interpretation No. 17, of AU section 508, which provides reporting guidance for audits of nonissuers. If this optional wording is added, the remainder of the paragraph should read as follows:

> "An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions."

[6] The auditor may identify the body requiring the information, such as the GASB in this example.

requirements for placement. If a government does not place GASB-required supplementary information in its financial report as required by GASB standards, the auditor should consider the effect of the placement on his or her report. Specifically, the auditor should consider whether to report that the RSI placement constitutes a presentation that departs materially from prescribed guidelines.

[Source: AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2008, paragraph 2.59]

.05 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: AU section 558 paragraph .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: AU section 558 paragraph .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: AU section 558 paragraph .11] (See paragraph .10.)

.06 Prescribed Procedures Not Completed Regarding Supplementary Information Required by the GASB

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements 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 opinions 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. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion.*][7] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof 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 pages XX through XX and XX through XX are 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*]

[Sources: AU section 558 paragraph .08; AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2008, paragraph 14.79, (appendix A, example A-1)]

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: AU section 558 paragraph .08]

GASB standards require the management's discussion and analysis, which is RSI, to precede the basic financial statements and most other RSI to be presented immediately following the notes to

[7] This optional wording may be added in accordance with Auditing Interpretation No. 17, of AU section 508, which provides reporting guidance for audits of nonissuers. If this optional wording is added, the remainder of the paragraph should read as follows:

"An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions."

the financial statements. Although AU section 558 paragraph .11 discusses alternative placement of RSI provided it is clearly marked as unaudited, that alternative is not available for GASB-required supplementary information given the GASB's specific requirements for placement. If a government does not place GASB-required supplementary information in its financial report as required by GASB standards, the auditor should consider the effect of the placement on his or her report. Specifically, the auditor should consider whether to report that the RSI placement constitutes a presentation that departs materially from prescribed guidelines. [Source: AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2008, paragraph 2.59]

.07 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: AU section 558 paragraph .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: AU section 558 paragraph .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: AU section 558 paragraph .11] (See paragraph .10.)

.08 Unresolved Doubts About Adherence to Guidelines Regarding Supplementary Information Required by GASB

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements 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 opinions 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. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion.*][8] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof 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 pages XX through XX and XX through XX are 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*]

[Sources: AU section 558 paragraph .08; AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2008, paragraph 14.79 (appendix A, example A-1)]

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: AU section 558 paragraph .08]

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[8] This optional wording may be added in accordance with Auditing Interpretation No. 17, of AU section 508, which provides reporting guidance for audits of nonissuers. If this optional wording is added, the remainder of the paragraph should read as follows:

> "An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions."

GASB standards require the management's discussion and analysis, which is RSI, to precede the basic financial statements and most other RSI to be presented immediately following the notes to the financial statements. Although AU section 558 paragraph .11 discusses alternative placement of RSI provided it is clearly marked as unaudited, that alternative is not available for GASB-required supplementary information given the GASB's specific requirements for placement. If a government does not place GASB-required supplementary information in its financial report as required by GASB standards, the auditor should consider the effect of the placement on his or her report. Specifically, the auditor should consider whether to report that the RSI placement constitutes a presentation that departs materially from prescribed guidelines.

[Source: AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2008, paragraph 2.59.]

.09 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: AU section 551 paragraph .12, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1)]

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.

[Source: AU section 551 paragraph .06]

.10 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: AU section 551 paragraph .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.

[Source: AU section 551 paragraph .06]

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.

.11 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 "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: AU section 551 paragraph .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.

[Source: AU section 551 paragraph .06]

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.

.12 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: AU section 551 paragraph .14 and AU section 508 paragraph .39, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), 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.

[Source: AU section 551 paragraph .06]

.13 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: AU section 551 paragraph .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. [Source: AU section 551 paragraph .06]

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 section 551 paragraphs .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.[9] [Source: AU section 551 paragraph .15]

In certain circumstances, the auditor's report should be expanded in accordance with AU section 558 paragraph .08–.09. The illustrative reports at paragraphs .01–.08 are assembled from illustrative reporting language in AU section 558 paragraph .08.

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[9] The auditor may identify the body requiring the information, such as the FASB in this example.

.14 Supplementary Information Required by the GASB Included in Auditor-Submitted Documents

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements 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 opinions 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. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion.*][10] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The [*identify accompanying required supplementary information*] on pages XX through XX and XX through XX are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America.[11] We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

[*Signature*]

[*Date*]

[Sources: AU section 551 paragraph .15; AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2008, paragraph 14.79 (appendix A, example A-1)]

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 auditor-submitted documents. [Source: AU section 551 paragraph .06]

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

[10] This optional wording may be added in accordance with Auditing Interpretation No. 17 of AU section 508, which provides reporting guidance for audits of nonissuers. If this optional wording is added, the remainder of the paragraph should read as follows:

> "An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions."

[11] The auditor may identify the body requiring the information, such as the GASB in this example.

information if the auditor has been engaged to examine the information, (*b*) report on the information using the guidance in AU section 551 paragraphs .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.

In certain circumstances, the auditor's report should be expanded in accordance with AU section 558 paragraphs .08 and .09. The illustrative reports at paragraphs .01–.08 are assembled from illustrative reporting language in AU section 558 paragraph .08 and the AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2008.

.15 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: AU section 551 paragraph .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."

.16 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 consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our 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 provided 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 the ABC 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 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: AU section 552 paragraph .10, *Reporting on Condensed Financial Statements and Selected Financial Data* (AICPA, *Professional Standards*, vol. 1)]

[*The next page is 9471.*]

AAM Section 9250

Engagements to Report on Internal Control

.01 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]

[*Signature*]

[*Date*]

[Source: AT section 501 paragraph .56, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1)]

[1] For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.02 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*].[2] 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*].[3]

[*Signature*]

[*Date*]

[Source: AT section 501 paragraph .58]

Note: Nothing precludes the practitioner from examining an assertion but opining directly on the effectiveness of internal control. (See AT section 501 paragraph .59.)

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[2] 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.

[3] For example, "criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

.03 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.

A material weakness is a significant deficiency or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. A significant deficiency is a control deficiency or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. The following material weakness has been identified.

[*Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.*]

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*].

[*Signature*]

[*Date*]

[Source: AT section 501 paragraph .63]

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.[4]

[Source: AT section 501 paragraphs .63 and .66]

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[4] The practitioner may also include the preceding sentence in situations where the two reports are not included within the same document.

.04 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.

A material weakness is a significant deficiency or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. A significant deficiency is a control deficiency or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. The following material weakness has been identified.

[*Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.*]

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*].

[*Signature*]

[*Date*]

[Source: AT section 501 paragraph .64]

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.[5]

[Source: AT section 501 paragraphs .64 and .66]

[5] The practitioner may also include the preceding sentence in situations where the two reports are not included within the same document.

.05 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.

A material weakness is a significant deficiency or a combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. A significant deficiency is a control deficiency or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected. The following material weakness has been identified. 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 prior to December 20, 20XX. 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*].

[*Signature*]

[*Date*]

[Source: AT section 501 paragraph .68]

.06 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.

[*Signature*]

[*Date*]

[Source: AT section 501 paragraph .70]

.07 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.*[6]]

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*].

[*Signature*]

[*Date*]

[Source: AT section 501 paragraph .72]

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[6] 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.

.08 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*].

[*Signature*]

[*Date*]

[Source: AT section 501 paragraph .77]

.09 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*].

[*Signature*]

[*Date*]

[Source: AT section 501 paragraph .79]

Notes: This report assumes that the control criteria of the regulatory agency are both suitable and available to users as discussed in AT section 101 paragraphs .23–.34, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1). 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.

.10 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.

[*Signature*]

[*Date*]

[Source: AT section 501 paragraph .82]

.11 Communication of Internal Control Matters Noted in an Audit

Addressee:

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control that we consider to be significant deficiencies [*and other deficiencies that we consider to be material weaknesses*].

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control. We consider the following deficiencies to be significant deficiencies in internal control:

[*Describe the significant deficiencies that were identified.*]

[*A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control. We believe that the following deficiencies constitute material weaknesses.*]

[*Describe the material weaknesses that were identified.*]

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any specified governmental authorities*] 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 written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

[Source: AU section 325 paragraphs .26 and .29, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1)]

.12 Communication of Internal Control Related Matters Noted in an Audit When the Auditor Has Not Identified Any Material Weaknesses and Wishes to Communicate That to Management and Those Charged With Governance

Addressee:

In planning and performing our audit of the financial statements of ABC Company as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered ABC Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any specified governmental authorities*] 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 written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

[Source: AU section 325 paragraphs .28–.29]

Notes: If one or more significant deficiencies have been identified, the auditor may add the following sentence to the fourth paragraph of the communication:

> However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [*date*].

.13 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 ___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,[7] and (3) such controls had been placed in operation as of __. The control objectives were specified by __. 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 ____. 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 ___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: AU section 324 paragraph .38, *Service Organizations* (AICPA, *Professional Standards*, vol. 1)]

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 AU section 324 paragraph .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 AU section 324 paragraph .40, for an example explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that there are sufficient deficiencies in the design or operation of the service organization's controls.

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[7] 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.

.14 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 ___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,[8] and (3) such controls had been placed in operation as of __. The control objectives were specified by __. 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 ____. 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 ___to ___. 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 __to __. [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.][9]

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 ____, and information about tests of the operating effectiveness of specific controls covers the period from ____to ____. 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.

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[8] 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.

[9] 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.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

[Source: AU section 324 paragraph .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 AU section 324 paragraph .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 AU section 324 paragraph .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.

.15 Reports on Internal Control Required by SEC Rule 17a-5

The following is an illustration of the independent auditor's report on internal control required by Securities Exchange Commission (SEC) rule 17a-5(g)(1):[*]

Board of Directors

Standard Stockbrokerage Co., Inc.

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), as of and for the year ended December 31, 20X7, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's 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 consideration of control activities for safeguarding securities. This study included 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(a)(11) and the reserve required by rule 15c3-3(e)
2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation 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

[*] For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), replaces this sentence with the following sentence: "We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States)." On May 14, 2004, the Securities and Exchange Commission (SEC) issued an interpretive release to help with the implementation of PCAOB Auditing Standard No. 1. See Release No. 33-8422 for more information. The release specifies that effective May 14, 2004, references in SEC rules and staff guidance and in the federal securities laws to GAAS or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB, plus any applicable rules of the SEC. The guidance in this release is applicable only to auditors' engagements that are governed by PCAOB rules. The PCAOB, for example, has not established particular auditing standards for nonissuer broker-dealers or investment advisers. This release is not applicable to such engagements and related filings.

The staff of the PCAOB published a series of questions and answers on PCAOB Auditing Standard No. 1. See the PCAOB Web site at www.pcaobus.org for more information.

In June 2004, the Auditing Standards Board (ASB) issued Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report of a Nonissuer" of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), which provides reporting guidance for audits of nonissuers. Interpretation No. 18 in AU section 9508 provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance with both GAAS and PCAOB auditing standards. The ASB also is revising AU section 508 (AICPA, *Professional Standards*, vol. 1) in light of the International Auditing and Assurance Standards Board's recently exposed International Standard on Auditing, The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements, and PCAOB Auditing Standard No. 1. See the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards for more information.

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 and 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.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency*[10] is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined above.[11]

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, as described in the second paragraph of this report, were adequate at December 31, 20X7, to meet the SEC's objectives.[12]

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[10] On May 24, 2007 the PCAOB approved PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements* (*PCAOB Standards and Related Rules*, Rules of the Board, "Standards"). The Securities and Exchange Commission (SEC) approved Auditing Standard No. 5 on July 25, 2007 and it is effective for all audits of internal control for fiscal years ending on or after November 15, 2007. Early adoption is permitted. Included in Auditing Standard No. 5 are new definitions for significant deficiency and material weakness:

> **Significant deficiency.** A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.
>
> **Material weakness.** A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

[11] If significant deficiencies are identified, this paragraph can be modified by inserting, "However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [*date*]." AU section 325 paragraph .29, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1), states that the auditor should not issue a written communication stating that no significant deficiencies were identified because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

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 this paragraph of the report should be modified as follows:

> However, we identified the following deficiencies in [internal control or control activities for safeguarding securities] that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of and for the year ended December 31, 20X6, and this report does not affect our report thereon dated February 15, 20X7. [*A description of the material weaknesses that have come to the auditor's attention and corrective action.*]

[12] Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 11. 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.

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, 20X8

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities,* updated as of May 1, 2007, appendix C]

Note: AAM section 9650 illustrates the auditor's reports on the financial statements of brokers and dealers in securities.

.16 Report on Internal Control Required by SEC Rule 17a-5 (g) (1) for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3

The following is an illustration of an independent auditor's report on internal control required by SEC Rule 17a-5(g)(1) for a broker-dealer claiming an exemption from Securities and Exchange Commission (SEC) rule 15c3-3.[13]

Board of Directors

Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), as of and for the year ended December 31, 20X7 in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's 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 consideration of control activities for safeguarding securities. This study included tests of such practices and procedures that we considered relevant to the objectives stated in rule 17a-5(g) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under rule 17a-3(a)(11) and for determining compliance with the exemptive provisions of rule 15c3-3. Because the Company does not carry securities accounts for customers or perform custodial functions relating to customer securities, we did not review the practices and procedures followed by the Company in any of the following:

1. Making quarterly securities examinations, counts, verifications, and comparisons and recordation of differences required by rule 17a-13

2. 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

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 and 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.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements

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[13] There are different types of exemptions under SEC Rule 15c3-3—k(1), k(2)(i), and k(2)(ii). Other formats of this letter will be required depending on the type of the exemption filed.

on a timely basis. A *significant deficiency*[14] is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined above.[15]

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, as described in the second paragraph of this report, were adequate at December 31, 20X7, to meet the SEC's objectives.[16]

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, 20X8

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities,* updated as of May 1, 2007, appendix D]

Note: AAM section 9650 illustrates the auditor's reports on the financial statements of brokers and dealers in securities.

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[14] On May 24, 2007 the PCAOB approved Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements*. The SEC approved Auditing Standard No. 5 on July 25, 2007 and it is effective for all audits of internal control for fiscal years ending on or after November 15, 2007. Early adoption is permitted. Included in Auditing Standard No. 5 are new definitions for *significant deficiency* and *material weakness*:

> **Significant deficiency.** A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.
>
> **Material weakness.** A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

[15] If significant deficiencies are identified, this paragraph can be modified by inserting " However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [*date*]." AU section 325 paragraph .29 (AICPA, *Professional Standards*, vol. 1) states that the auditor should not issue a written communication stating that no significant deficiencies were identified because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

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 this paragraph of the report should be modified as follows:

> However, we identified the following deficiencies in [internal control or control activities for safeguarding securities] that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of and for the year ended December 31, 20X7, and this report does not affect our report thereon dated February 15, 20X8. [*A description of the material weaknesses that have come to the auditor's attention and corrective action.*]

[16] Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 15. 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.

.17 Letter to SEC When the Broker-Dealer Has Not Made the Required Notification

The following report is appropriate if the broker-dealer has not made the required notification of material inadequacy or if the auditor does not agree with the statements therein. Modification of this letter may be required based on the facts and circumstances of the particular situation.

Securities and Exchange Commission
Washington D.C., and [*Appropriate regional office*]
Designated Examining Authority

Dear Sirs:

Our most recent audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), was as of December 31, 20X6, and for the year then ended, which we reported on under date of February 15, 20X7. We have not audited any financial statements of the Company as of any date or for any period subsequent to December 31, 20X6. Although we are presently performing certain procedures as part of our audit of the [*consolidated*] financial statements of the Company as of December 31, 20X7, 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 the 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 are recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles.

Because of inherent limitations in internal control, error 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 identify all material weaknesses in internal control and 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, 20X7

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities,* updated as of May 1, 2007, appendix E]

Note: AAM section 9650 illustrates the auditor's reports on the financial statements of brokers and dealers in securities.

.18 Report on Internal Control Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)

The following is an illustration of the independent auditor's report on internal control required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1).

Board of Directors
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company) as of and for the year ended December 31, 20X7, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's 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 consideration of control activities for safeguarding securities. This study included 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(a)(11) and the reserve required by Rule 15c3-3(e)

2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation 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.

In addition, 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 Company including consideration of control activities for safeguarding customer and firm assets. This study included 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(a)(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 Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraphs. 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 paragraphs and to assess whether those practices and procedures can be expected to achieve the SEC's and 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 Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) and Regulation 1.16(d)(2) list additional objectives of the practices and procedures listed in the preceding paragraphs.

Because of inherent limitations in internal control and 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.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency*[17] is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first, second and third paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities and certain regulated commodity customer and firm assets that we consider to be material weaknesses, as defined above.[18]

We understand that practices and procedures that accomplish the objectives referred to in the second and third paragraphs of this report are considered by the SEC and CFTC to be adequate for their purposes in accordance with the Securities Exchange Act of 1934, 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 Company's practices and procedures, as described in the second and third paragraphs of this report, were adequate at December 31, 20X7, to meet the SEC's and CFTC's objectives.[19]

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[17] On May 24, 2007 the PCAOB approved Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements*. The SEC approved Auditing Standard No. 5 on July 25, 2007 and it is effective for all audits of internal control for fiscal years ending on or after November 15, 2007. Early adoption is permitted. Included in Auditing Standard No. 5 are new definitions for significant deficiency and material weakness:

> **Significant deficiency.** A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.
>
> **Material weakness.** A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

[18] If significant deficiencies are identified, this paragraph can be modified by inserting " However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [*date*]." AU section 325 paragraph .29 (AICPA, *Professional Standards*, vol.1) states that the auditor should not issue a written communication stating that no significant deficiencies were identified because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

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 this paragraph of the report should be modified as follows:

> However, we identified the following deficiencies in [internal control or control activities for safeguarding securities and certain regulated commodity customer and firm assets] that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of and for the year ended December 31, 20X7, and this report does not affect our report thereon dated February 15, 20X8. [*A description of the material weaknesses that have come to the auditor's attention and corrective action*.]

[19] Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 18. 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 and the CFTC.

This report is intended solely for the information and use of the Board of Directors, management, the SEC, the CFTC, [*Designated Self-Regulatory Organization*] and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 or Regulation 1.16 of the CFTC or both in their regulation of registered broker-dealers and futures commission merchants, 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, 20X8

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities,* appendix F]

[*The next page is 9521.*]

AAM Section 9260

Special Reports

.01 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: AU section 623 paragraph .08, *Special Reports* (AICPA, *Professional Standards*, vol. 1)]

Note: See the AICPA publication *Cash and Tax Basis Financial Statements—Checklists and Illustrative Financial Statements* for further guidance on the unique recognition, measurement, and disclosure issues for other comprehensive basis of accounting (OCBOA) financial statements, including illustrative financial statements and notes. Call the AICPA at (888) 777-7077 and ask for product number WTX-CL to order.

.02 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 [*at*] 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: AU section 623 paragraph .08]

.03 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 audits provide 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: AU section 623 paragraph .08]

.04 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 presents 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: AU section 623 paragraph .18]

.05 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 of royalties. 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: AU section 623 paragraph .18]

.06 Profit Participation

(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 this schedule 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: AU section 623 paragraph .18]

.07 Report on Federal and State Income Taxes in Financial Statements

(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: AU section 623 paragraph .18]

.08 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.

Bank	*General Ledger Account Balances as of December 31, 20XX*
ABC National Bank	$ 5,000
DEF State Bank	3,776
XYZ Trust Company regular account	86,912
XYZ Trust Company payroll account	5,000
	$110,688

We found no exceptions as a result of the procedures.

Accounts Receivable

2. We added the individual customer account balances shown in an aged trial balance of accounts receivable (identified as exhibit A) and compared the resultant total with the balance in the general ledger account.

   We found no difference.

3. We compared the individual customer account balances shown in the aged trial balance of accounts receivable (exhibit A) as of December 31, 19XX, to the balances shown in the accounts receivable subsidiary ledger.

   We found no exceptions as a result of the comparisons.

4. We traced the aging (according to invoice dates) for 50 customer account balances shown in exhibit A to the details of outstanding invoices in the accounts receivable subsidiary ledger. The balances selected for tracing were determined by starting at the eighth item and selecting every fifteenth item thereafter.

   We found no exceptions in the aging of the amounts of the 50 customer account balances selected. The sample size traced was 9.8 percent of the aggregate amount of the customer account balances.

5. We mailed confirmations directly to the customers representing the 150 largest customer account balances selected from the accounts receivable trial balance, and we received responses as indicated below. We also traced the items constituting the outstanding customer account balance to invoices and supporting shipping documents for customers from which there was no reply. As agreed, any individual differences in a customer account balance of less than $300 were to be considered minor, and no further procedures were performed.

   Of the 150 customer balances confirmed, we received responses from 140 customers; 10 customers did not reply. No exceptions were identified in 120 of the confirmations received. The differences disclosed in the remaining 20 confirmation replies were either minor in amount (as defined above) or were reconciled to the customer account balance without proposed adjustment thereto. A summary of the confirmation results according to the respective aging categories is as follows.

	Accounts Receivable December 31, 20XX		
Aging Categories	*Customer Account Balances*	*Confirmations Requested*	*Confirmations Received*
Current	$156,000	$ 76,000	$ 65,000
Past due:			
Less than one month	60,000	30,000	19,000
One to three months	36,000	18,000	10,000
Over three months	48,000	48,000	8,000
	$300,000	$172,000	$102,000

We were not engaged to and did not 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.

[*Signature*]

[*Date*]

[Source: AT section 201 paragraph .48, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1)]

.09 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 the 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.

   [*Signature*]

   [*Date*]

   [Source: AT section 201 paragraph .48]

.10 Reporting on the Subject Matter

Independent Accountants Report
on Attest Engagements on Financial Information[1]
Included in XBRL Instance Documents

We have examined the accompanying XBRL Instance Document of XYZ Company, which reflects the data presented in the financial statements of XYZ Company as of December 31, 20XX, and for the year then ended [*optional to include the location of the financial statements, such as "included in the Company's Form 10-K for the year ended December 31, 20XX"*]. XYZ Company's management is responsible for the XBRL Instance Document. Our responsibility is to express an opinion based on our examination.

We have also audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company as of December 31, 20XX, and for the year then ended, and in our report dated [*Month*] XX, 20XX, we expressed an unqualified opinion on those financial statements.[2] [3]

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting the XBRL Instance Document and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, the XBRL Instance Document of XYZ Company referred to above accurately reflects, in all material respects, the data presented in the financial statements in conformity with [*identify the criteria—for example, specific XBRL taxonomy, such as the "XBRL U.S. Consumer and Industrial Taxonomy," and where applicable, the company extension taxonomy, such as "XYZ Company's extension taxonomy," and the XBRL International Technical Specifications 2.0*].

[*Signature*]

[*Date*]

[Interpretation No. 5, "Attest Engagements on Financial Information Included in XBRL Instance Documents" of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1, AT sec. 9101 par. .47–.55).]

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[1] Financial information includes data presented in audited or reviewed financial statements or other financial information (for example, Management Discussion and Analysis).

[2] If the financial statements have been reviewed, the sentence would read: "We have also reviewed, in accordance with [*standards established by the American Institute of Certified Public Accountants*] [*Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants*], the financial statements of XYZ Company as of March 31, 20XX, and for the three months then ended, the objective of which was the expression of limited assurance on such financial statements, and issued our report thereon dated [*Month*] XX, 20XX, [*describe any modifications of such report*]."

If the financial information has not been audited or reviewed, no reference to a report is required. The sentence would read: "We were not engaged to and did not conduct an audit or review of the [*identify information*], the objectives of which would have been the expression of an opinion or limited assurance on such [*identify information*]. Accordingly, we do not express an opinion or any other assurance on [*it*] [*them*]."

[3] If the audit opinion on the related financial statements is other than unqualified, the practitioner should disclose that fact, and any substantive reasons therefore.

.11 Reporting on Management's Assertions

Independent Accountants Report on
Attest Engagements on Financial Information[4]
Included in XBRL Instance Documents

We have examined management's assertion that [*identify the assertion—for example, the accompanying XBRL Instance Document accurately reflects the data presented in the financial statements of XYZ Company as of December 31, 20XX, and for the year then ended in conformity with (identify the criteria—for example, specific XBRL taxonomy, such as the "XBRL U.S. Consumer and Industrial Taxonomy," and where applicable, the company extension taxonomy, such as "XYZ Company's extension taxonomy," and the XBRL International Technical Specifications 2.0)*]. XYZ Company's management is responsible for the assertion. Our responsibility is to express an opinion on the assertion based on our examination.

We have also audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company as of December 31, 20XX, and for the year then ended, and in our report dated [*Month*] XX, 20XX, we expressed an unqualified opinion on those financial statements.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting the XBRL Instance Document and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management's assertion referred to above is fairly stated, in all material respects, in conformity with [*identify the criteria—for example, specific XBRL taxonomy, such as the "XBRL U.S. Consumer and Industrial Taxonomy," and where applicable, the company extension taxonomy, such as "XYZ Company's extension taxonomy," and the XBRL International Technical Specifications 2.0*].

[*Signature*]

[*Date*]

[Source: AT section 9101 paragraphs .47–.55]

[4] Financial information includes data presented in audited or reviewed financial statements or other financial information (for example, Management Discussion and Analysis).

.12 Compliance With Contractual Provisions (Separate Report)

Independent Auditor's 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: AU section 623 paragraph .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.

.13 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 special-purpose statement of assets and liabilities of ABC Company as of December 31, 20X2 and 20X1, and the related special-purpose statements of revenues and expenses and of 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 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 discussed 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 at December 31, 20X2 and 20X1, and the revenues, expenses and 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 boards of directors and management 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: AU section 623 paragraph .30]

.14 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 Corporation) 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: AU section 623 paragraph .26]

.15 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 sold 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: AU section 623 paragraph .26]

.16 Report on the Application of Accounting Principles

Introduction

We have been engaged to report on the appropriate application of accounting principles generally accepted in [*country of origin of such principles*] 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:

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 [*country of origin of such principles*] for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountant. Our judgment on the appropriate application of accounting principles generally accepted in [*country of origin of such principles*] 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: AU section 625 paragraph .11, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1)]

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: AU section 625 paragraph .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: AU section 625 paragraph .04]

.17 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 Property and Liability Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Property and Liability 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.[5] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 Property and Liability Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows[6] 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 Property and Liability Company as of December 31, 20X2 and 20X1,

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[5] For audits conducted in accordance with PCAOB standards, PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), replaces this sentence with the following sentence: "We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States)." On May 14, 2004, the SEC issued an interpretive release to help with the implementation of PCAOB Auditing Standard No. 1. See Release No. 33-8422 for more information. The release specifies that effective May 24, 2004, references in SEC rules and staff guidance and in federal securities laws to GAAS or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB, plus any applicable rules of the SEC. The staff of the PCAOB published a series of questions and answers (Q&A) on PCAOB Auditing Standard No. 1. See the PCAOB Web site at www.pcaobus.org for more information.

In June 2004, the Auditing Standards Board (ASB) issued Interpretation No. 18 in AU section 9508, "Reference to PCAOB Standards in an Audit Report of a Nonissuer" (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .89–.92), which provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance with both GAAS and PCAOB auditing standards. The ASB also has undertaken a project to determine what amendments, if any, should be made to AU section 508. See the AICPA Web site at www.aicpa.org/members/div/auditstd/index.htm for more information.

This optional wording may be added in accordance with Interpretation No. 17 in AU section 9508, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards" (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88), which was issued by the ASB in June 2004 and provides reporting guidance for audits of nonissuers. Auditing Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph should read as follows:

> An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

[6] Reference to cash flows would not be needed if the entity, under generally accepted accounting principles, is not required to present a statement of cash flows.

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 *Property and Liability Insurance Companies*, updated as of September 1, 2006, paragraph 8.30]

[*The next page is 9571.*]

AAM Section 9270

Unaudited Financial Statements of a Public Entity

.01 Disclaimer

(When an accountant is associated with the financial statements but has not audited or reviewed such statements)

Addressee:

The accompanying balance sheet of X Company as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: AU section 504 paragraph .05, *Association With Financial Statements* (AICPA, *Professional Standards*, vol. 1)]

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 2610 and 2620.

.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: AU section 504 paragraphs .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 2610 and 2620.

.03 Disclaimer—Cash Basis Statements

(When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles)

Addressee:

The accompanying statement of assets and liabilities resulting from cash transactions of XYZ Corporation as of December 31, 19X1, and the related statement of revenues collected and expenses paid during the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: AU section 504 paragraph .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 2610 and 2620.

.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: AU section 504 paragraph .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 2610 and 2620.

[*The next page is 9621.*]

AAM Section 9280

Lack of Independence

.01 Disclaimer

Addressee:

We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 19X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: AU section 504 paragraph .10, *Association With Financial Statements* (AICPA, *Professional Standards*, vol. 1)]

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 accountant must consider the guidance in Statements on Standards for Accounting and Review Services (SSARS). (See AAM section 2610 paragraph .03.)

[*The next page is 9671.*]

AAM Section 9300

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 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: AU section 722 paragraph .38, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1)]

Note: 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 AU section 722 paragraph .02.

[*The next page is 9701.*]

AAM Section 9400

Accountants' Reports on Condensed Financial Statements and Selected Financial Data

.01 Unqualified Opinion on Condensed Financial Statements

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: AU section 552 paragraph .06, *Reporting on Condensed Financial Statements and Selected Financial Data* (AICPA, *Professional Standards*, vol. 1)]

.02 Adverse Opinion on Condensed Financial Statements Due to Inadequate Disclosure

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 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 the results of its operations or its cash flows for the year then ended.

[*Signature*]

[*Date*]

[Source: AU section 552 paragraph .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 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 reviews, we are not aware of any material modifications that should be made to the condensed 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: AU section 722 paragraph .39, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1)]

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 9751.*]

AAM Section 9500

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*]. 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 statement of financial condition is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statement 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*, updated as of May 1, 2007, 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*, updated as of May 1, 2007, 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*], or the changes in their net worth for the [*period*] then ended.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, updated as of May 1, 2007, 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, these 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*, updated as of May 1, 2007, paragraph 5.18]

.05 Audit Report—Disclaim Opinion Because of Scope Limitation—Inadequate Records

Independent Auditor's Report

Addressee:

I (We) were 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.

Since 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*, updated as of May 1, 2007, 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 discussed 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 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*, updated as of May 1, 2007, 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 worth for the [*period*] then ended on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Source: AICPA *Personal Financial Statements Guide*, updated as of May 1, 2007, 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*, updated as of May 1, 2007, 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*, updated as of May 1, 2007, 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*, updated as of May 1, 2007, 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*, updated as of May 1, 2007, 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*, updated as of May 1, 2007, paragraph 5.13]

.12 Compilation Report—Income Tax Basis

Addressee:

I (We) have compiled the accompanying statement of assets and liabilities—income tax basis of James and Jane Person as of [*date*], and the related statement of changes in net assets—income tax basis for the [*period*] then ended, 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*, updated as of May 1, 2007, paragraph 5.20]

.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*, updated as of May 1, 2007, 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*, updated as of May 1, 2007, 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*, updated as of May 1, 2007, 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*, updated as of May 1, 2007, 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*, updated as of May 1, 2007, paragraph 5.20]

[*The next page is 9801.*]

AAM Section 9600

Reports on Employee Benefit Plans

Practice Tip
Audits of 11-K Filers—Performance and Reporting Requirements

SEC Requirements

The Securities and Exchange Commission (SEC) requires employee stock purchase, savings and similar plans with interests that constitute securities registered under the Securities Act of 1933 to file Form 11-K pursuant to Section 15(d) of the Securities Exchange Act of 1934. Reports on Form 11-K must be filed with the SEC within 90 days after the end of the fiscal year of the plan, provided that plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) file the plan financial statements within 180 days after the plan's fiscal year end.

Applicable Audit Standards

Plans that are required to file Form 11-Ks are deemed to be *issuers* under the Sarbanes-Oxley Act and must submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the Public Company Accounting Oversight Board (PCAOB).

Performance and Reporting Requirements

Based on AICPA staff discussions with the SEC and PCAOB staff to seek clarification of the performance and reporting requirements for audits of 11-K filers, firms will need to conduct their audits of these 11-K plans in accordance with two sets of standards and prepare two separate audit reports; an audit report referencing PCAOB standards for Form 11-K filings with the SEC and a separate audit report referencing generally accepted auditing standards (GAAS) for Department of Labor (DOL) filings. The PCAOB and SEC staff believe that an opinion issued in accordance with PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), does not allow a reference to GAAS, hence a "dual" standard report is not appropriate and will not be accepted by the SEC.

Any questions regarding performance and reporting requirements of audits of financial statements of Form 11-K filers should be directed to the SEC Division of Corporation Finance, Office of the Chief Accountant at (202) 942-2960.

.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. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion.*][1] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 *Employee Benefit Plans*, updated as of March 1, 2008, 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.

[1] This optional language may be added to the auditor's standard report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the Sarbanes-Oxley Act is applicable. If this optional language is added then the remainder of the paragraph should read as follows:

> "An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion."

See Auditing Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88).

.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. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion.*][2] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 *Employee Benefit Plans,* updated as of March 1, 2008, paragraph 13.05]

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[2] This optional language may be added to the auditor's standard report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the Sarbanes-Oxley Act is applicable. If this optional language is added then the remainder of the paragraph should read as follows:

> "An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion."

See Auditing Interpretation No. 17 of AU section 508.

.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. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion.*][3] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 *Employee Benefit Plans*, updated as of March 1, 2008, paragraph 13.06]

[3] This optional language may be added to the auditor's standard report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the Sarbanes-Oxley Act is applicable. If this optional language is added then the remainder of the paragraph should read as follows:

> "An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion."

See Auditing Interpretation No. 17 of AU section 508.

.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. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion.*][4] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 *Employee Benefit Plans*, updated as of March 1, 2008, paragraph 13.07]

[4] This optional language may be added to the auditor's standard report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the Sarbanes-Oxley Act is applicable. If this optional language is added then the remainder of the paragraph should read as follows:

> "An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion."

See Auditing Interpretation No. 17 of AU section 508.

.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 title of schedules and period covered*) 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 *Employee Benefit Plans*, updated as of March 1, 2008, 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 paragraphs .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. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion.*][5] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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*]

[5] This optional language may be added to the auditor's standard report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the Sarbanes-Oxley Act is applicable. If this optional language is added then the remainder of the paragraph should read as follows:

> "An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion."

See Auditing Interpretation No. 17 of AU section 508.

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, updated as of March 1, 2008, paragraph 13.22]

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. Auditing Interpretation No. 14, "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)" of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 9623 par. .90–.95), 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 *Employee Benefit Plans*, updated as of March 1, 2008, paragraph 13.23]

.07 Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations

Following are examples of paragraphs that have been added to the auditor's report when the auditor modifies 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 paragraphs .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 title of schedules and period covered*] 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) as of December 31, 20X2 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 for the year ended December 31, 20X2. 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 *Employee Benefit Plans,* updated as of March 1, 2008, paragraph 13.16]

.08 Qualified Opinion—Omitted or Incomplete Schedule or Material Inconsistency

The following are examples of paragraphs that have been added to the auditor's report when the auditor qualifies his or her opinion on the supplemental schedules 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 paragraphs .01–.03.]

The supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2 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 title of schedules and period covered*] 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 *Employee Benefit Plans,* updated as of March 1, 2008, paragraph 13.16]

.09 Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following are examples of paragraphs that have been added to the auditor's report on the plan's financial statements when the auditor qualifies his or her opinion 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 paragraphs .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 title of schedules and period covered*] 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 *Employee Benefit Plans*, updated as of March 1, 2008, paragraph 13.17]

.10 Adverse Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following are examples of paragraphs that have been 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 paragraphs .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 title of schedules and period covered*] 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 *Employee Benefit Plans,* updated as of March 1, 2008, paragraph 13.17]

.11 Modified Report—Disclosure of Immaterial Prohibited Transaction With Party in Interest Omitted

The following are examples of paragraphs that have been 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 paragraphs .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 title of schedules and period covered*] 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 *Employee Benefit Plans,* updated as of March 1, 2008, 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 title of schedules and period covered*] 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 *Employee Benefit Plans,* updated as of March 1, 2008, 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.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of March 1, 2008, paragraph 13.26]

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 *Employee Benefit Plans,* for wording of such a paragraph). [Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of March 1, 2008, paragraph 13.26, 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.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, updated as of March 1, 2008, paragraph 13.28]

.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 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 *Employee Benefit Plans,* updated as of March 1, 2008, paragraph 13.29]

.16 Initial Limited-Scope Audit in Current Year, Prior Year Limited-Scope Audit Performed by Other Auditors

Report of Independent Certified Public Accountants

Addressee:

We were engaged to audit the accompanying statements of net assets available for benefits of ABC Company Profit-Sharing Plan (the "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 Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2. These financial statements and supplemental schedule are the responsibility of the Plan's management. The financial statements of the plan as of December 31, 20X1 were audited by other auditors. 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 ("ERISA"), the Plan administrator instructed the other auditors not to perform and they did not perform, any auditing procedures with respect to the information certified by the Trustee. Their report, dated May 20, 20X2, indicated that (*a*) because of the significance of the information that they did not audit, they were unable to, and did not, express an opinion on the financial statements taken as a whole and (*b*) the form and content of the information included in the financial statements other than that derived from the information certified by the Trustee, were presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA.

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 E, which was certified by Bank & Trust Company, the trustee of the Plan, except for comparing such information with the related information included in the 20X2 financial statements and supplemental schedule. 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 trustee as of and for the year ended December 31, 20X2, that the information provided to the Plan administrator by the trustee is complete and accurate.

Because of the significance of the information in the Plan's 20X2 financial statements and supplemental schedule that we did not audit, we are unable to, and do not, express an opinion on the accompanying 20X2 financial statements and supplemental schedule taken as a whole. The form and content of the information included in the 20X2 financial statements and supplemental schedule, 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, 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 *Employee Benefit Plans,* updated as of March 1, 2008, paragraph 13.30]

.17 Limited Scope Audit—Change in Trustee

Report of Independent Certified Public Accountants

Addressee:

We were engaged to audit 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, and the supplemental schedules of (1) Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2, and (2) Schedule H, line 4j—Schedule of Reportable Transactions for the year ended December 31, 20X2. These financial statements and schedules are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the investment information summarized in Note X, which was certified by the ABC Bank and XYZ Trust Company, the trustees 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 XYZ Trust Company held the Plan's investment assets and executed investment transactions from July 1, 20X2 to December 31, 20X2, and that ABC Bank held the Plan's investment assets and executed investment transactions as of December 31, 20X1 and for the period January 1, 20X1 to June 30, 20X2. The plan administrator has obtained certifications from the trustees as of and for the years ended December 31, 20X2 and 20X1, that the information provided to the plan administrator by the trustees 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 investment information certified by the trustees, have been audited by us in accordance with auditing standards generally accepted in the United States 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 *Employee Benefit Plans,* updated as of March 1, 2008, paragraph 13.31]

.18 Audit of Multiemployer Defined Benefit Pension Plan With Scope Limitation

Independent Auditor's Report

Addressee:

We were engaged to audit the statements of (*identify title of schedules and period covered*) 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 *Employee Benefit Plans,* updated as of March 1, 2008, paragraph 13.32]

.19 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 paragraph .13.]

The supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2 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 for the year ended December 31, 20X2. 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 *Employee Benefit Plans,* updated as of March 1, 2008, paragraph 13.16]

.20 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 *Employee Benefit Plans,* updated as of March 1, 2008, paragraph 13.33]

.21 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. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion.*][6] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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

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[6] This optional language may be added to the auditor's standard report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the Sarbanes-Oxley Act is applicable. If this optional language is added then the remainder of the paragraph should read as follows:

> "An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion."

See Auditing Interpretation No. 17 of AU section 508.

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 *Employee Benefit Plans*, updated as of March 1, 2008, paragraph 13.38]

.22 **Form 11-K Filing**

Report of Independent Registered Public Accounting Firm

Addressee:

We have audited the accompanying statements of net assets available for benefits of the ABC 401(k) plan (the "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 the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our 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 U.S. generally accepted accounting principles.

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, updated as of March 1, 2008, paragraph 13.19]

Note: ***Reporting Considerations for Nonaccelerated Filer Audit Reports.*** In an audit of a nonaccelerated filer that has determined it is not required to obtain, nor did it request the auditor to perform, an audit of internal control over financial reporting (under Section 404(b) of the Sarbanes-Oxley Act of 2002 and Item 308(b) of SEC Regulation S-K), firms may wish to consider expanding their audit report to include a statement that the purpose and extent of the auditor's consideration of internal control over financial reporting were to determine that the nature, timing, and extent of tests to be performed are appropriate in the circumstances but were not sufficient to express an opinion on the effectiveness of internal control over financial reporting. Firms are not required to expand their audit report to include this statement. However, the SEC staff has indicated that if a firm chooses to expand its report to clarify this point, the language in Auditing Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .89–.92), provides appropriate language to consider in an audit conducted in accordance with PCAOB standards. Accordingly, the scope section of the auditor's report might be modified as follows:

> We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (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 Plan is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting.***

> ***Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion.*** An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As an alternative to the first additional sentence suggested by Auditing Interpretation 18 of AU section 508, a firm also might consider the following: A second alternative would be to use language from Auditing Interpretation No. 2, "Reports by Management on Internal Control Over Financial Reporting" of AU Section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9550 par. .07–.11). Paragraph .10 of Auditing Interpretation No. 2 of AU section 550 states, "Although not required, the auditor may consider adding the following paragraph to the standard auditor's report:

> ***We were not engaged to examine management's assertion about the effectiveness of [name of entity's] internal control over financial reporting as of [date] included in the accompanying [title of manage-ment's report] and accordingly, we do not express an opinion thereon.***

[This information is from the Center for Audit Quality (CAQ)—CAQ Alert #2007-66—December 19, 2007.]

[*The next page is 9851.*]

AAM Section 9650

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, 20X7, 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.[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. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.*][2] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 [*consolidated*] financial statements referred to above present fairly, in all material respects, the financial position of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of December 31, 20X7, and the results of its [their] operations and its [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

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[1] In June 2004, the Auditing Standards Board (ASB) issued Auditing Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report of a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .89–.92), which provides reporting guidance for audits of nonissuers. Auditing Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance with both GAAS and PCAOB auditing standards.

[2] This optional wording may be added in accordance with Auditing Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88), which was issued by the ASB in June 2004 and provides reporting guidance for audits of nonissuers. Auditing Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing, and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph should read as follows:

> "An audit also 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, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion."

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*, updated as of May 1, 2007, appendix A]

Notes:

SEC Regulation S-X section 210.2-02 (17 CFR 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 9250 paragraphs .15–.16 contain illustrative reports on internal control required by SEC Rule 17a-5.

[*] Paragraph .23 of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), states that the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements.

.02 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, 20X7, and have issued our report thereon dated February 15, 20X8. 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,* updated as of May 1, 2007, appendix B]

Note: This paragraph can be shown separately in the auditor-submitted document or as a separate paragraph, after the opinion paragraph, of the auditor's standard report.

[*The next page is 9901.*]

AAM Section 9700

Reports for Investment Companies

.01 Unqualified Opinion on the Financial Statements of a Registered Investment Company

Report of Independent Registered Public Accounting Firm

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[1] 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.[2] 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 the standards of the Public Company Accounting Oversight Board (United States). 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 *Investment Companies*, updated as of May 1, 2007, paragraph 11.09]

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. When broker confirmations are not received and alternative procedures are performed, the sentence may be modified to read "and brokers or by other appropriate auditing procedures

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[1] 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.

[2] In an open-end fund's registration statement, an auditor must opine on at least the most recent two of the five years of financial highlights presented in a registered investment company's annual report. In the fund's registration statement, the auditor must opine on all five years presented.

where replies from brokers were not received." Also, if securities were physically inspected or subject to other extended procedures for purposes of the audit, the report should be modified to state that those procedures were performed.

.02 Unqualified Opinion on the Financial Statements for a Multicolumnar Presentation of the Portfolios Constituting the Series

Report of Independent Registered Public Accounting Firm

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[3] 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 the standards of the Public Company Accounting Oversight Board (United States). 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 *Investment Companies,* updated as of May 1, 2007, paragraph 11.13]

[3] See footnote 1.

.03 Unqualified Opinion on the Financial Statements Presenting One of the Portfolios or Entities Constituting the Series

Report of Independent Registered Public Accounting Firm

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[4] 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 the standards of the Public Company Accounting Oversight Board (United States). 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 *Investment Companies*, updated as of May 1, 2007, paragraph 11.14]

[4] See footnote 1.

.04 Unqualified Opinion on the Financial Statements of a Nonregistered Investment Company

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company (the Company), including the schedule of investments, as of December 31, 20X4, and the related statements of operations, cash flows[5] and changes in net assets, and the financial highlights for the year 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 audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America.[6] 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. An audit also includes 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 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, its cash flows, the changes in its net assets, and its financial highlights 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 *Investment Companies,* updated as of May 1, 2007, paragraph 11.02]

[*The next page is 10,001.*]

[5] See footnote 1.

[6] AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), states that a basic element of the auditor's report is a statement that the audit was conducted in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards. Auditing 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 AU section 508 (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .56–.59) states that if the audit also was conducted in accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. This can be done by modifying this sentence as follows (new language is shown in italics):

> We conducted our audit in accordance with auditing standards generally accepted in the United States of America *and in accordance with International Standards on Auditing*.

AAM Section 10,000
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 must consider the guidance in professional standards and should rely on their individual professional judgment in determining what may be needed in individual circumstances.

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[*The next page is 10,101.*]

AAM Section 10,100

Quality Control—General

AICPA Requirements

.01 ET section 57 Article VI, *Scope and Nature of Services*, of the AICPA's "Principles of Professional Conduct" (AICPA, *Professional Standards*, vol. 2), states that "members should practice in firms that have in place internal quality-control procedures to ensure that services are competently delivered and adequately supervised." A firm must establish a system of quality control designed to provide the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the firm or engagement partners issue reports that are appropriate in the circumstances. A system of quality control consists of policies designed to achieve these objectives and the procedures necessary to implement and monitor compliance with those policies.

.02 The AICPA issues Statements on Quality Control Standards to establish standards and provide guidance to firms on establishing and maintaining a quality control system for their accounting and auditing practices. In October 2007, the AICPA issued Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, vol. 2, QC sec. 10). SQCS No. 7 is effective as of January 1, 2009, and supersedes all extant SQCSs.

.03 Presented in AAM section 10,200 is a *Practice Aid for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, updated for the issuance of SQCS No. 7. Following the practice aid in AAM section 10,300 are sample quality control forms to aid practitioners in implementing a quality control system.

[*The next page is 10,201.*]

AAM Section 10,200

Practice Aid for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Revised for the Issuance of Statement on Quality Control Standards No. 7, A Firm's System of Quality Control

NOTICE TO READERS

This AICPA Audit and Accounting Practice Aid updates *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, which was issued in 2004. This practice aid is intended to help practitioners better understand and apply Statement on Quality Control Standards (SQCS) No. 7 issued by the AICPA. That standard is included in appendix A of this practice aid. This version of the practice aid, prepared by the Quality Control Standards Task Force, has been revised to incorporate new policies and procedures that a firm should consider including in its system of quality control to be responsive to the issuance of SQCS No. 7. The policies and procedures presented in this practice aid are illustrative, and firms are encouraged to consider them in designing and maintaining a system of quality control that is appropriate for their accounting and auditing practices. Some of the policies and procedures presented in this practice aid are not required by the SQCSs; however, they represent the views of the task force regarding best practices for a quality control system. Although this practice aid has been reviewed by the AICPA Audit and Attest Standards staff, it has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA and has no official or authoritative status.

The Sarbanes-Oxley Act of 2002 (Act) created the Public Company Accounting Oversight Board (PCAOB) and charged it with overseeing audits of issuers,[1] as defined by the act. Under the act, the PCAOB's duties include, among other things, establishing auditing, quality control, ethics, independence, and other standards relating to audits of issuers.

This practice aid does not address the quality control requirements of the act, nor does it address the quality control requirements of PCAOB standards that must be followed by auditors of issuers. Auditors of issuers should follow these other standards and make changes to their firm's quality control systems as necessary. Auditors of nonissuers who are engaged to report on audit engagements in accordance with PCAOB auditing standards also must report on those engagements in accordance with generally accepted auditing standards (GAAS). Auditing Interpretations No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," and No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer" of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 9508 par. .85–.88 and par. .89–.92, respectively), provide reporting guidance for audits of nonissuers when the auditor is asked to report in accordance with GAAS and PCAOB auditing standards.

Additional information about the PCAOB and the act can be obtained at the PCAOB Web site at www.pcaobus.org.

[1] Paragraph 7 of Section 2, "Definitions," of the Sarbanes-Oxley Act of 2002 states, "The term *issuer* means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 [15 U.S.C. 78c]), the securities of which are registered under section 12 of that act [15 U.S.C. 78l], or that is required to file reports under section 15(d) [15 U.S.C. 78o(d)], or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 [15 U.S.C. 77a et seq.], and that it has not withdrawn."

Quality Control Standards Task Force (2007)

David T. Brumbeloe, *Chair*

Sheila M. Birch

Michael L. Brand

Gerald W. Burns

Robert D. Dohrer

Thomas J. Lantz, Sr.

Thomas J. Parry

Richard W. Reeder

Walter H. Webb

Mark E. Ziessman

AICPA Staff

Charles E. Landes
Vice President
Professional Standards and Services

Ahava Z. Goldman
Technical Manager
Audit and Attest Standards

Chapter 1:

Overview of Statements on Quality Control Standards

1.01 The objectives of a system of quality control are to provide a CPA firm with reasonable assurance[1] that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the circumstances. SQCS No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, vol. 2, QC sec. 10), was issued by the Auditing Standards Board (ASB) of the AICPA in October 2007 and is effective for a firm's accounting and auditing practice as of January 1, 2009. This standard supersedes all previously issued SQCSs.

1.02 A system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The nature, extent, and formality of a firm's quality control policies and procedures will depend on various factors such as the firm's size; the number and operating characteristics of its offices; the degree of authority allowed to, and the knowledge and experience possessed by, firm personnel; and the nature and complexity of the firm's practice.

Communication of Quality Control Policies and Procedures

1.03 The firm should communicate its quality control policies and procedures to its personnel. Most firms will find it appropriate to communicate their policies and procedures in writing and distribute, or make available electronically, them to all professional personnel.

1.04 Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve.
- The message that each individual has a personal responsibility for quality.
- A requirement for each individual to be familiar with and to comply with these policies and procedures.

Effective communication also includes procedures for personnel to communicate their views or concerns on quality control matters to the firm's management.

Elements of a System of Quality Control

1.05 A firm's system of quality control should include policies and procedures that address each of the following elements of quality control identified in SQCS No. 7:

- Leadership responsibilities for quality within the firm (the "tone at the top")
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

[1] The term *reasonable assurance*, which is defined as a high, but not absolute, level of assurance, is used because absolute assurance cannot be attained. Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, vol. 2, QC sec. 10), states, "Any system of quality control has inherent limitations that can reduce its effectiveness."

1.06 The elements of quality control are interrelated. For example, a firm continually assesses client relationships to comply with relevant ethical requirements, including independence, integrity, and objectivity, and policies and procedures related to the acceptance and continuance of client relationships and specific engagements. Similarly, the human resources element of quality control encompasses criteria related to professional development, hiring, advancement, and assignment of firm personnel to engagements, all of which affect policies and procedures related to engagement performance. In addition, policies and procedures related to the monitoring element of quality control enable a firm to evaluate whether its policies and procedures for each of the other five elements of quality control are suitably designed and effectively applied.

1.07 If a firm merges, acquires, sells, or otherwise changes a portion of its practice, the surviving firm evaluates and, as necessary, revises, implements, and maintains firm-wide quality control policies and procedures that are appropriate for the changed circumstances.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

1.08 The objective of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. The firm should establish and maintain the following policies and procedures to satisfy this objective:

- Require the firm's leadership (managing partner, board of managing partners or CEO, or equivalent) to assume ultimate responsibility for the firm's system of quality control.
- Assign management responsibilities so that commercial considerations do not override the quality of the work performed.
- Assign operational responsibility for the firm's quality control system to personnel who have sufficient and appropriate experience and ability to identify and understand quality control issues and to develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.
- Design policies and procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm's overarching commitment to the objectives of the system of quality control.
- Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

Relevant Ethical Requirements

1.09 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Establishing and maintaining policies such as the following ordinarily would satisfy this objective:

- Require that personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office (GAO), and any other applicable regulators.
- Establish procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.
- Establish procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.
- Require that the firm withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.

- Require written confirmation, at least annually, of compliance with the firm's policies and procedures on independence from all firm personnel required to be independent by relevant requirements.
- Establish procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of the engagement. This would apply to national firm personnel, foreign firm personnel, and foreign-associated firms.[2]
- Require the rotation of personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.

Acceptance and Continuance of Client Relationships and Specific Engagements

1.10 The objective of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
- is competent to perform the engagement and has the capabilities and resources to do so;
- can comply with legal and ethical requirements; and
- has reached an understanding with the client regarding the services to be performed.

1.11 This objective ordinarily should be satisfied before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client by establishing and maintaining policies such as the following:

- Evaluate factors that have a bearing on management's integrity and consider the risk associated with providing professional services in particular circumstances.[3]
- Evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.
- Obtain an understanding, preferably in writing, with the client regarding the services to be performed.
- Establish procedures on withdrawal from an engagement or from both the engagement and the client relationship, including procedures for dealing with information that would have caused the firm to decline an engagement if the information had been available earlier.
- Require documentation of how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.

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[2] A foreign-associated firm is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international firm or international association of firms.

[3] Such considerations would include the risk of providing professional services to significant clients or to other clients for which the practitioner's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a member or a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. Examples of factors to consider in determining the significance of a client to an engagement partner, office, or practice unit include (*a*) the amount of time the partner, office, or practice unit devotes to the engagement, (*b*) the effect on the partner's stature within the firm as a result of his or her service to the client, (*c*) the manner in which the partner, office, or practice unit is compensated, or (*d*) the effect that losing the client would have on the partner, office, or practice unit.

Human Resources

1.12 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Establishing and maintaining policies such as the following ordinarily would satisfy this objective:

- Recruit and hire personnel of integrity who possess the characteristics that enable them to perform competently.
- Determine capabilities and competencies required for an engagement, especially for the engagement partner, based on the characteristics of the particular client, industry, and kind of service being performed. Specific competencies necessary for an engagement partner are discussed in paragraph 45 of SQCS No. 7.
- Determine the capabilities and competencies possessed by personnel.
- Assign the responsibility for each engagement to an engagement partner.
- Assign personnel based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.
- Have personnel participate in general and industry-specific continuing professional education and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable continuing professional education requirements of the AICPA, state boards of accountancy, and other regulators.
- Select for advancement only those individuals who have the qualifications necessary to fulfill the responsibilities they will be called on to assume.

Engagement Performance

1.13 The objectives of the engagement performance element of quality control are to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (*b*) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed.

1.14 The objectives of the engagement performance element of quality control ordinarily would be satisfied by establishing and maintaining policies such as the following:

- Plan all engagements to meet professional, regulatory, and the firm's requirements.
- Perform work and issue reports and other communications that meet professional, regulatory, and the firm's requirements.
- Require that work performed by other team members be reviewed by qualified engagement team members, which may include the engagement partner, on a timely basis.
- Require the engagement team to complete the assembly of final engagement files on a timely basis.
- Establish procedures to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.
- Require the retention of engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.

- Require that
  - — consultation take place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues);
  - — sufficient and appropriate resources be available to enable appropriate consultation to take place;
  - — all the relevant facts known to the engagement team be provided to those consulted;
  - — the nature, scope, and conclusions of such consultations be documented; and
  - — the conclusions resulting from such consultations be implemented.
- Require that
  - — differences of opinion be dealt with and resolved;
  - — conclusions reached are documented and implemented; and
  - — the report not be released until the matter is resolved.
- Require that
  - — all engagements be evaluated against the criteria for determining whether an engagement quality control review should be performed;
  - — an engagement quality control review be performed for all engagements that meet the criteria; and
  - — the review be completed before the report is released.
- Establish procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.
- Establish criteria for the eligibility of engagement quality control reviewers.

Monitoring

1.15 The objective of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports issued by the firm are appropriate in the circumstances

1.16 The objective of the monitoring element of quality control ordinarily would be satisfied by establishing and maintaining policies such as the following:

- Assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.
- Assign performance of the monitoring process to competent individuals.
- Require the performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures. Monitoring procedures consist of the following:

— Review of selected administrative and personnel records pertaining to the quality control elements

— Review of engagement working papers, reports, and clients' financial statements

— Summarization of the findings from the monitoring procedures, at least annually, and consideration of the systemic causes of findings that indicate that improvements are needed

— Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures

— Communication of the identified findings to appropriate firm management personnel

— Consideration of findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis

— Assessment of

a. The appropriateness of the firm's guidance materials and any practice aids;

b. New developments in professional standards and regulatory and legal requirements and how they are reflected in the firm's policies and procedures where appropriate;

c. Compliance with policies and procedures on independence;

d. The effectiveness of continuing professional development, including training;

e. Decisions related to acceptance and continuance of client relationships and specific engagements; and

f. Firm personnel's understanding of the firm's quality control policies and procedures and implementation thereof.

- Communicate at least annually, to relevant engagement partners and other appropriate personnel, deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.
- Communicate the results of the monitoring of its quality control system process to relevant firm personnel at least annually.
- Establish procedures designed to provide the firm with reasonable assurance that it deals appropriately with the following. This includes establishing clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisal and documenting complaints and allegations and the responses to them:

  — Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements

  — Allegations of noncompliance with the firm's system of quality control

  — Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations

- Require appropriate documentation to provide evidence of the operation of each element of its system of quality control. The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including the following, for example:

  — The size of the firm and the number of offices

  — The nature and complexity of the firm's practice and organization

- Require retention of documentation providing evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures and peer review to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

1.17 Some of the monitoring procedures discussed in the previous list may be accomplished through the performance of the following:

- Engagement quality control review
- Postissuance review of engagement working papers, reports, and clients' financial statements for selected engagements
- Inspection[4] procedures

Documentation of Quality Control Policies and Procedures

1.18 The firm should document each element of its system of quality control. The extent of the documentation will depend on the size, structure, and nature of the firm's practice. Documentation may be as simple as a checklist of the firm's policies and procedures or as extensive as practice manuals.

Applying the Quality Control Standards to Four Hypothetical Firms

1.19 Subsequent chapters in this practice aid present four different hypothetical firms and the quality control policies and procedures each firm implements to address each of the quality control elements. Following is a description of those firms and their characteristics:

- Multioffice CPA Firm has 10 offices in 3 states and is centrally managed. It has approximately 15 partners and 100 professionals. Its accounting and auditing practice has a concentration of financial institution clients for which it performs audit and attest services. Multioffice CPA Firm has no issuer clients. (chapter 2)
- Single office CPA Firm has 1 office, 3 partners, and 10 professionals. Its accounting and auditing practice has a concentration of employee benefit plan audits. Single office CPA Firm has no issuer clients. (chapter 3)
- Sole Practitioner, CPA, is a sole owner who has no professional staff and occasionally hires per diem professionals. Her accounting practice consists only of engagements subject to Statements on Standards for Accounting and Review Services (SSARSs). (chapter 4) (Note: Sole practitioners who perform audit and attest engagements should refer to chapter 3)
- Closely Aligned CPA Firm and Non-CPA-Owned Entity are organized in an *alternative practice structure*, which is a nontraditional structure in the practice of public accounting consisting of an attest and a nonattest portion of the practice. The attest portion is conducted through a firm, Closely Aligned CPA Firm, owned and controlled by CPAs. The nonattest portion is conducted through a separate entity, Non-CPA-owned Entity, owned and controlled by individuals who are not CPAs. (chapter 5)

1.20 The policies and procedures described in each chapter are those that a firm of a similar size and type may consider establishing and maintaining. The policies and procedures used by an actual firm need not necessarily include nor be limited to all those used by the illustrative firms.

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[4] Inspection is a retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with them. Although monitoring procedures are meant to be ongoing, they may include inspection procedures performed at a fixed point in time. Monitoring is a broad concept; inspection is one specific type of monitoring procedure.

Chapter 2:

System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Firm With Multiple Offices

2.01 This chapter describes how a CPA firm that has multiple offices (Multioffice CPA Firm) implements each element of quality control in its accounting and auditing practice. Multioffice CPA Firm is a hypothetical firm that has 10 offices in 3 states and is centrally managed. Multioffice CPA Firm has 15 partners, 100 professionals, and a concentration of financial institution clients for which it performs audit and attest services. The firm uses 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. It has no issuer clients.[1]

Quality Control Policies and Procedures

2.02 The firm's system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those polices. The policies and procedures are required to be documented. Multioffice CPA Firm documents its system of quality control by preparing a document that comprehensively describes policies and procedures established and maintained for each element of quality control. Multioffice CPA Firm reviews the documentation at least annually and updates it as necessary.

2.03 The firm should communicate its quality control policies and procedures to its personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

2.04 Multioffice CPA Firm communicates these policies and procedures in writing and makes the documentation available electronically to all professional personnel. Multioffice CPA Firm requires each individual to be familiar with and to comply with these policies and procedures. Multioffice CPA Firm also includes procedures for personnel to communicate their views or concerns on quality control matters to partners.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

2.05 The objective of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. Multioffice CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 2.06–.10.

2.06 *Policy 1: The firm's managing partner assumes ultimate responsibility for the firm's system of quality control.* Multioffice CPA Firm implements this policy through the following procedures:

- Having the managing partner accept overall responsibility for the firm's system of quality control and promoting a quality-oriented culture by sending clear, consistent, and frequent messages through e-mails, letters, and recordings
- Having a mission statement that includes the firm's core values and the importance of quality
- Informing personnel that failure to adhere to the firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action

[1] If Multioffice CPA Firm were to be engaged to perform audit services for an issuer, it might need to revise its quality control policies and procedures to comply with Public Company Accounting Oversight Board (PCAOB) standards and to reflect Securities and Exchange Commission (SEC) requirements applicable to audits of issuers.

2.07 *Policy 2: The firm assigns management responsibilities so that commercial considerations do not override the quality of the work performed.* Multioffice CPA Firm implements this policy through the following procedures:

- Having the managing partner continually evaluate client relationships and specific engagements so that commercial considerations do not override the objectives of the system of quality control
- Emphasizing to all personnel that fee considerations and scope of services should not infringe upon quality work

2.08 *Policy 3: The firm assigns operational responsibility for the firm's quality control system to personnel who have sufficient and appropriate experience and ability to identify and understand quality control issues and to develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.* Multioffice CPA Firm implements this policy through the following procedures:

- Designating a quality control partner with overall operational responsibility for developing and implementing appropriate policies and procedures for the firm's quality control system
- Designating a quality control individual for each office

2.09 *Policy 4: The firm designs procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm's overarching commitment to the objectives of the system of quality control.* Multioffice CPA Firm implements this policy through the following procedures:

- Designing and implementing performance evaluation and advancement systems that (*a*) reward partners and staff involved in the accounting and auditing practice for the quality of their work and their compliance with professional standards and (*b*) include partner performance peer evaluations
- Establishing a compensation system that provides incentives to accounting and auditing partners and senior-level employees for the quality of their accounting and auditing work. The compensation system does the following:
  - — Takes into consideration firm feedback based on monitoring results and peer reviews of the work performed
  - — Rewards partners and personnel for timely (*a*) identification of significant and emerging accounting and auditing issues and (*b*) consultation with firm experts

2.10 *Policy 5: The firm devotes sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.* Multioffice CPA Firm implements this policy through the following procedures:

- Providing the designated quality control partner with sufficient time, authority, and resources to develop, implement, and maintain the firm's quality control policies and procedures
- Providing the firm's quality control documentation to personnel when they are initially hired and reviewing the documentation with them
- Reviewing the firm's quality control policies and procedures with personnel at firm training sessions at least annually

Relevant Ethical Requirements

2.11 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Multioffice CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 2.12–.18.

2.12 *Policy 1: Personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the GAO, and any other applicable regulators.* Multioffice CPA Firm implements this policy through the following procedures:

- Assigning one of its partners the responsibility of responding to questions, resolving matters, and determining the circumstances for which consultation with sources outside the firm is required for matters related to independence, integrity, and objectivity
- Identifying circumstances for which documentation of the resolution of matters is appropriate
- Maintaining a current list of (*a*) all entities with which firm personnel are prohibited from having a financial or business relationship and (*b*) all activities in which the firm is prohibited[2] from engaging, as defined in the firm's independence policies
- Establishing clear and concise written independence guidance covering relationships and activities that impair independence, including but not limited to investments, loans, brokerage accounts, business relationships, employment relationships, and fee arrangements

2.13 *Policy 2: The firm establishes procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.* Multioffice CPA Firm implements this policy through the following procedures:

- Having the managing partner (through e-mails, letters, or recordings) emphasize the concepts of independence, integrity, and objectivity in the firm's professional development meetings, in the acceptance and continuance of clients and engagements, and in the performance of engagements. Because Multioffice CPA Firm has a concentration of financial institution clients, this also includes discussing the applicability of these concepts to engagements for financial institutions, such as the prohibition against any member of the engagement team having a "nongrandfathered" loan with the institution, and the types of nonattest services that could affect independence.
- Requiring periodic independence and ethics training for all professional personnel. Such training covers the firm's independence and ethics policies and the independence and ethics requirements of all applicable regulators.
- Providing frequent reminders of professional responsibilities to personnel, such as avoiding behavior that might be perceived as impairing their independence or objectivity.
- Informing personnel on a timely basis of those entities to which independence policies apply by doing the following:
    - — Preparing and maintaining a list of entities with which firm personnel are prohibited from having a financial or business relationship
    - — Making the list available to personnel so they may evaluate their independence (including personnel new to the firm or an office)
    - — Notifying personnel of changes in the list

2.14 *Policy 3: The firm establishes procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.* Multioffice CPA Firm implements this policy through the following procedures:

- Assigning a partner who is not otherwise associated with the engagement, or who practices in an office other than the office that performs the attest engagement, to review the engagement
- Requiring approval of the assignment of engagement personnel by another partner or manager
- Rotating engagement partners periodically

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[2] Examples of prohibited activities include providing certain valuation and information technology services to an audit client. See the rules of specific standard-setters to determine the extent and relevance of any prohibition.

- Establishing additional procedures that provide safeguards when the firm performs audit or other attest work for (*a*) significant clients or (*b*) clients at which partners or other senior personnel are offered key management positions, or accept offers of employment, by utilizing the procedures contained in the AICPA Code of Professional Conduct, paragraphs .01 and .04 of ET section 100, *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*, vol. 2)
- Designating a senior-level partner to be responsible for overseeing the adequate functioning of the firm's independence policies
- Implementing a system to identify investment holdings of partners and managers that might impair independence
- Requiring all professionals to report, on a timely basis when identified, apparent violations of independence, integrity, or objectivity policies involving themselves, their spouses, or their dependents and the corrective actions taken or proposed to be taken
- Establishing a requirement for all professional personnel to notify the managing partner in each office of any potential activities that might impair independence or violate ethics rules, including services provided to entities with which firm personnel are prohibited from having a business relationship
- Establishing a program that protects professional personnel who report potential ethics or independence violations to the proper parties in compliance with firm policy
- Requiring the managing partner in each office, or a person designated by the managing partner, to periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence
- Developing guidance that sets forth the consequences for professional personnel who violate the firm's independence policies and procedures, including engaging in activities with entities with which firm personnel are prohibited from having a business relationship
- Requiring all professional personnel to review the list of entities with which firm personnel are prohibited from having a business relationship before a professional or the spouse or dependent of a professional obtains a security or financial interest in an entity
- Establishing criteria that determine the need for safeguards for engagements where monitoring procedures or peer review have identified weaknesses in previous years or the same senior personnel have been used for five years or more on an audit or attestation engagement
- Documenting any safeguards applied to eliminate threats to independence or reduce them to an acceptable level
- Promptly communicating identified breaches of these policies and procedures, and the required corrective actions, to (*a*) the engagement partner who, with the firm, needs to address the breach and (*b*) other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action
- Obtaining confirmation from the engagement partner and other relevant personnel that the required corrective actions have been taken

2.15 *Policy 4: The firm withdraws from engagements if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.* Multioffice CPA Firm implements this policy through the following procedures:

- Consulting within the firm and, if necessary, with legal counsel and other parties when the firm believes that effective safeguards to reduce threats to independence to an acceptable level cannot be applied
- Withdrawing from engagements when effective safeguards to reduce threats to independence to an acceptable level cannot be applied

2.16 *Policy 5: The firm obtains written confirmation, at least annually, of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant requirements.* Multioffice CPA Firm implements this policy through the following procedures:

- Obtaining written representations from personnel, upon hire and on an annual basis, stating that they have read the firm's independence, integrity, and objectivity policies, understand the applicability of those policies to their activities, and have complied with the requirements of those policies since their last representation (such written representations are accompanied by the most current list of all entities with which firm personnel are prohibited from having a financial or business relationship)
- Assigning responsibility to the firm's quality-control partner for obtaining such written representations, reviewing independence compliance files for completeness, and resolving reported exceptions
- Requiring the engagement partner to sign a step in the engagement program attesting to compliance with independence requirements that apply to the engagement

2.17 *Policy 6: The firm establishes procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of an engagement.* Multioffice CPA Firm implements this policy through the following procedures:

- Describing in its policies and procedures manual the form and content of independence representations, and frequency with which they are to be obtained
- Requiring that such representations be documented

2.18 *Policy 7: The firm rotates personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.* Multioffice CPA Firm implements this policy by having the quality control partner monitor regulatory requirements for financial institutions and other entities and notifying partners of the need for rotation. Multioffice CPA Firm has decided to rotate partners assigned to audit financial institutions every five years.

Acceptance and Continuance of Client Relationships and Specific Engagements

2.19 The objective of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
- is competent to perform the engagement and has the capabilities and resources to do so;
- can comply with legal and ethical requirements; and
- has reached an understanding with the client regarding the services to be performed.

2.20 Multioffice 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 policies and procedures described in paragraphs 2.21–.25.

2.21 *Policy 1: The firm evaluates factors that have a bearing on management's integrity and considers the risk associated with providing professional services in particular circumstances.* Multioffice CPA Firm implements this policy through the following procedures:

- Developing and maintaining a manual that contains policies and procedures related to the acceptance of prospective clients and the continuance of existing 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.
- Advising professional personnel that they are expected to be familiar with the firm's policies and procedures for the acceptance and continuance of clients.
- Obtaining and evaluating relevant information before accepting or continuing any client. The following are examples of such information:
  - The nature and purpose of the services to be provided and management's understanding thereof.
  - The identity of the client's principal owners, key management, related parties, and those charged with its governance.
  - The nature of the client's operations, including its business practices, from sources such as annual reports, interim financial statements, reports to regulators, enforcement actions by regulators, and income tax returns.
  - Information obtained from inquiries of third parties about the client, its principal owners, key management, and those charged with governance that may have a bearing on evaluating the client. Examples of such third parties are bankers, factors, legal counsel, credit services, investment bankers, underwriters, and other members of the financial or business community who may have applicable knowledge. Inquiries also might be made regarding management's attitude toward compliance with regulators or legislative requirements and the presence of control deficiencies, especially those that management is unwilling to correct.
- Communicating with the predecessor accountant or auditor when required or recommended by professional standards. This communication also includes inquiries regarding the nature of any disagreements and whether there is evidence of opinion shopping.
- Assessing management's commitment to implementing and maintaining effective internal control.
- Assessing management's commitment to the appropriate application of generally accepted accounting principles (GAAP).
- Conducting a background check of the business, its officers, and the person(s) in question by using an investigative firm and evaluating the information obtained regarding management's integrity. Background checks are conducted when the firm is unable to obtain sufficient information about the prospective client after completing the steps listed previously, or when there is an indication that management or someone affiliated with the prospective client may be less than reputable.
- Evaluating the risk of providing services to significant clients or to other clients for which the firm's independence or the appearance of independence may be impaired. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (*a*) the amount of time the partner devotes to the engagement, (*b*) the effect on the partner's stature within the firm as a result of his or her service to the client, (*c*) the manner in which the partner is compensated, and (*d*) the effect that losing the client would have on the partner and the firm.

2.22 *Policy 2: The firm evaluates whether the engagement can be completed with professional competence; undertakes only those engagements for which the firm has the capabilities, resources, and professional competence to* *complete; and evaluates, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.* Multioffice CPA Firm implements this policy through the following procedures:

- Evaluating whether the following are in place:
  - — The practice office has sufficient personnel who have obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements.
  - — Specialists are available if needed, through, for example, the resources of another practice office or alternative source.
  - — The firm is able to complete the engagement within the reporting deadline.
- Defining high-risk engagements.
- Specifying conditions that trigger the requirement between annual audits to reevaluate a client or engagement. The following are examples of such conditions:
  - — Significant changes in the client, such as a major change in ownership, senior client personnel, directors, advisers, the nature of the business, or its financial stability.
  - — Changes in the nature or scope of the engagement, such as an initial public offering or a request to step down from an audit to a review engagement.
  - — Changes in the composition or strategic focus of the firm, such as the inability to replace the loss of key personnel who are particularly knowledgeable about a specialized industry or a decision by Multioffice CPA firm 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, such as aggressive earnings management, unreliable processes for developing 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.
  - — The client's delinquency in paying fees. (This may also affect the firm's independence.)
  - — Engagements for entities operating in highly specialized or regulated industries, such as financial institutions, governmental entities, and employee benefit plans.
  - — Engagements for entities in the development stage.
  - — Engagements in which the client has ignored prior recommendations, such as recommendations that address deficiencies in internal control.
- Obtaining relevant information to determine whether the relationship should be continued and establishing the frequency with which client continuance evaluations should be made.
- Evaluating the information obtained regarding acceptance or continuance of a client or engagement through the following activities:
  - — The engagement partner assesses the information obtained about the client or the specific engagement, including information about the significance of the client to the firm, and makes a recommendation about whether the client or engagement should be accepted or continued.
  - — The engagement partner completes a client acceptance form and submits it to the managing partner of the practice office for approval.
  - — The engagement partner signs a step in the planning program noting that he or she has considered whether the client should be continued, and if conditions exist that trigger the requirement between annual audits to reevaluate a client or engagement, prepares a form documenting his or her rationale and conclusion regarding client continuance.

— The partner responsible for the quality control function assesses and approves the recommendation made by the engagement partner. In certain defined circumstances, such as high-risk engagements, acceptance or continuance decisions also may require approval of the firm's managing partner.

- Establishing procedures for dealing with information that would have caused the firm to decline the engagement if the information had been available earlier.

2.23 *Policy 3: The firm obtains an understanding with the client regarding the services to be performed.* Multioffice CPA Firm implements this policy by requiring that for all engagements, the firm prepare a written engagement letter documenting the understanding with the client and obtain the client's signature on that letter, thus minimizing the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed.

2.24 *Policy 4: The firm establishes procedures on withdrawal from an engagement or from both the engagement and the client relationship.* Multioffice CPA Firm implements this policy through the following procedures:

- Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances
- Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place or for the firm to report to regulatory authorities the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal
- Discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement, or from both the engagement and the client relationship, if the firm determines that it is appropriate to withdraw

2.25 *Policy 5: The firm documents how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.* Multioffice CPA Firm implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

Human Resources

2.26 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Multioffice CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 2.27–.33.

2.27 *Policy 1: Personnel who are hired possess the characteristics that enable them to perform competently.* Multioffice CPA Firm implements this policy by maintaining firm-wide hiring standards and evaluating the firm's personnel needs, including the following:

- Designating a partner or other qualified individual in each office to be responsible for evaluating the overall personnel needs in that practice office and establishing hiring objectives based on factors such as existing 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 for evaluating personal characteristics such as integrity, competence, and motivation
- Establishing guidelines for the additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions

- Preparing budgets that identify personnel needs at all levels
- Identifying sources of employment candidates such as universities and executive recruiters
- 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, including approval by the managing partner, or a person designated by the managing partner, of all hiring decisions

2.28 *Policy 2: The firm determines capabilities and competencies required for an engagement, including those required of the engagement partner.* Multioffice CPA Firm implements this policy by specifying the competencies that the engagement partner for an accounting, auditing, or attest engagement (or other person responsible for supervising and signing or authorizing someone to sign the firm's report on such engagements) should possess. Such competencies include having an understanding of the following:

- The role of the firm's system of quality control and the AICPA Code of Professional Conduct, both of which play critical roles in ensuring the integrity of the accounting, auditing, and attest function to users of reports.
- The performance, supervision, and reporting aspects of the engagement, which ordinarily are gained through training or participation in similar engagements.
- The industry in which the client operates, including its organization and operating characteristics, sufficient to identify areas of high or unusual risk associated with the engagement and to evaluate the reasonableness of industry-specific estimates.
- The professional standards applicable to the engagement being performed and to the industry in which the client operates. Such standards include accounting, auditing, and attestation standards, as well as rules and regulations issued by applicable regulators.
- The skills that contribute to sound professional judgment, including the ability to exercise professional skepticism.
- How the organization uses information technology and the manner in which information systems are used to record and maintain financial information.

2.29 *Policy 3: The firm determines the capabilities and competencies possessed by personnel.* Multioffice CPA Firm implements this policy through the following procedures:

- Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation
- Evaluating personnel at least annually to determine their capabilities and competencies

2.30 *Policy 4: The firm assigns responsibility for each engagement to an engagement partner.* Multioffice CPA Firm implements this policy through the following procedures:

- Assigning the responsibility for each engagement to an engagement partner who has the appropriate capabilities, competence, authority, and time to perform the role
- Clearly defining and communicating the responsibilities of the partner to the engagement partner
- Communicating the identity and role of the partner to management and those charged with governance
- Developing and maintaining systems to monitor the workload and availability of engagement partners to enable these individuals to have sufficient time to adequately discharge their responsibilities

2.31 *Policy 5: The firm assigns personnel (including partners) based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.* Multioffice CPA Firm implements this policy through the following procedures:

- Designating an appropriate person(s) in each office to be responsible for assigning personnel to engagements based on such factors as the following:
    - Engagement type, size, significance, complexity, and risk profile
    - Specialized experience or expertise required and competencies gained through previous experience or education
    - Need for and availability of staff and supervisors
    - Timing of the work to be performed
    - Continuity and rotation of personnel
    - Opportunities for on-the-job training
    - Situations for which independence or objectivity concerns exist
- Designating a partner to be responsible for partner and manager assignments
- Requiring approval of partner and manager assignments from the industry partner or the quality assurance partner in the case of high-risk or significant client engagements
- Establishing a policy for monitoring the continuation and rotation of engagement partners

2.32 *Policy 6: Personnel participate in general and industry-specific continuing professional education (CPE) and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state boards of accountancy, and other applicable regulators.* Multioffice CPA Firm implements this policy through the following procedures:

- Designating a partner to oversee the development of firm requirements and materials for a professional development program covering subjects relevant to the firm's clients and services. Such responsibilities include the following:
    - Encouraging personnel to pass the Uniform CPA Examination
    - Establishing guidelines for participation by personnel in professional development programs and considering the requirements of the AICPA, state boards of accountancy, and applicable regulators in establishing the firm's CPE requirements
    - Maintaining appropriate documentation evidencing that personnel have met the professional education requirements of the firm, the AICPA, state boards of accountancy, and other applicable regulators
    - Providing an orientation program and training for new personnel to inform them of their professional responsibilities and firm policies
    - Preparing and providing publications and programs to inform personnel of their responsibilities and opportunities
    - Developing in-house staff training programs that focus on general and industry-specific accounting and auditing subjects, including audits of financial institutions
- Communicating and distributing to personnel changes in accounting, auditing, attestation, and quality control standards, as well as independence, integrity, and objectivity requirements and the firm's guidance with respect to those standards and requirements
- Encouraging professional personnel at each level in the firm to participate in external professional development activities such as the following:
    - CPE courses
    - Meetings of professional organizations
    - Serving on professional committees
    - Writing for professional publications

— Speaking to professional groups

2.33 *Policy 7: Personnel selected for advancement have the qualifications necessary to fulfill the responsibilities they will be called on to assume.* Multioffice CPA Firm implements this policy through the following procedures:

- Appointing a director of human resources to identify and communicate, in the firm's policies and procedures manual, the qualifications necessary to accomplish responsibilities at each professional level in the firm. This includes the following:
  - Establishing criteria for evaluating personnel at each professional level and for advancement to the next higher level of responsibility. Such criteria give recognition and reward to the development and maintenance of competence and commitment to ethical principles.
  - Developing evaluation forms for each professional staff classification, including partners. Such forms include evaluation of performance quality and adherence to ethical principals.
  - Informing personnel that failure to adhere to the firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action.
- Assigning responsibility to a partner for making advancement and termination decisions for staff and recommendations to the firm's management committee for manager and partner-level advancement and termination. Such responsibilities include the following:
  - Identifying responsibilities and requirements for evaluation at each level and indicating who will prepare these evaluations and when they will be prepared
  - Reviewing evaluations on a timely basis with the individual being evaluated
- Advising personnel regarding their progress and career opportunities through the following procedures:
  - Evaluating employees annually and at the end of each assignment exceeding three weeks to provide feedback on performance.
  - Summarizing and reviewing with personnel their performance evaluations, including assessing their progress with the firm, at least annually. Considerations include past performance, future objectives of the firm and the individual, assignment preferences, and career opportunities.
  - Evaluating partners periodically by means of performance reviews, peer evaluations, or self-appraisals, as appropriate, to provide feedback and to determine whether they continue to have the qualifications to accomplish their assigned responsibilities and to assume additional responsibilities.

Engagement Performance

2.34 The objective of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (*b*) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. Multioffice CPA Firm satisfies these objectives by establishing and maintaining the policies and procedures described in paragraphs 2.35–.45.

2.35 *Policy 1: Planning for engagements meets professional, regulatory, and the firm's requirements.* Multioffice CPA Firm implements this policy by developing, maintaining, and providing personnel with the firm's policies and procedures manual that delineates the factors the engagement team should consider in the planning process and the extent of documentation of these considerations. Planning considerations may vary depending on the size and complexity of the engagement. Planning generally includes the following activities:

- Assigning responsibility to the engagement partner for planning the engagement and assigning responsibilities to appropriate personnel during the planning phase
- Developing or updating background information about the client
- Considering client significance to the firm
- Requiring, for all initial audit clients designated as high risk by the firm, an independent review of planning considerations by either the engagement quality control reviewer or another partner
- Requiring planning documentation that includes the following:
    - Proposed work programs tailored to the specific engagement
    - Staffing requirements, including the need for personnel with specialized knowledge who may have to be obtained from other practice offices
    - Consideration of the economic conditions affecting the client and its industry and their potential effect on the conduct of the engagement
    - Consideration of risks and how they may affect the procedures to be performed
    - A budget that allocates sufficient time for the engagement to be performed in accordance with professional standards and the firm's quality control policies and procedures
    - Evidence of review of planning by an independent review partner

2.36 *Policy 2: The engagement is performed, supervised, reviewed, documented, and reported (or communicated) in accordance with the requirements of professional standards, applicable regulators, and the firm.* Multioffice CPA Firm implements this policy by requiring personnel to comply with the firm's policies and procedures manual, which prescribes the following:

- How engagement teams are supervised during the course of an engagement, including briefing the engagement team on the objectives of their work
- The form and content of documentation of the work performed and conclusions reached, including forms, checklists, and questionnaires to be used in performing engagements
- The form in which instructions are to be given to other offices or other auditors performing part of an engagement and the extent to which such work is to be reviewed and documented
- The extent of overall engagement review required, at all professional levels, to ensure that the financial statements meet professional and firm presentation and disclosure requirements
- The extent of review to be performed of required communications to management and the board of directors

2.37 *Policy 3: Qualified engagement team members review work performed by other team members on a timely basis.* Multioffice CPA Firm implements this policy through the following procedures:

- Adhering to the following firm guidelines regarding review of documentation of the work performed and conclusions reached, the financial statements, and reports and documentation of the review process:
    - All reviewers are to possess appropriate experience, competence, authority, and responsibility and are to be given access to the firm's reference material and other resources.

— For each engagement, there is to be appropriate documentation evidencing review of the documentation of the work performed and conclusions reached, the financial statements, and the report.

- Assigning responsibility for the review of all reports, financial statements, and documentation of the work performed and conclusions reached to an appropriate reviewer in accordance with procedures outlined in the firm's manual to obtain reasonable assurance of the following:
  - — The nature, timing, and extent of procedures performed are consistent with risk assessments and the approach described in the planning documentation. Exceptions are appropriately investigated. The appropriateness of planned procedures should be reconsidered if significant changes in risk factors occur or are identified between the planning phase of the engagement and the execution of procedures.
  - — Firm-prescribed forms, checklists, and questionnaires, tailored as appropriate, are used in performing and reporting on the engagement.
- Requiring a second review, by a partner or manager, of the report, financial statements, and selected documentation of the work performed and conclusions reached, as prescribed in the firm's policies and procedures manual. The extent of review varies based on the type of engagement. For example, engagements for financial institutions, high-risk engagements, and those performed for significant clients, as defined by the firm, receive an engagement quality control review.
- Reviewing engagement documentation to determine whether the following has occurred:
  - — The work has been performed in accordance with professional standards and regulatory and legal requirements.
  - — Significant findings and issues have been raised for further consideration.
  - — Appropriate consultations have taken place, and the resulting conclusions have been documented and implemented.
  - — The nature, timing, and extent of work performed are appropriate and do not need revision.
  - — The work performed supports the conclusions reached and is appropriately documented.
  - — The evidence obtained is sufficient and appropriate to support the report.
  - — The objectives of the engagement procedures have been achieved.

2.38 *Policy 4: Engagement teams complete the assembly of final engagement files on a timely basis.* Multioffice CPA Firm implements this policy by completing the assembly of final engagement files in accordance with professional standards and applicable regulatory requirements, if any.

2.39 *Policy 5: The firm maintains the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.* Multioffice CPA Firm implements this policy through the following procedures:

- Establishing and applying controls to accomplish the following:
  - — Clearly determine when and by whom engagement documentation was prepared and reviewed.
  - — Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means.
  - — Prevent unauthorized changes to the engagement documentation.
  - — Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

- Requiring the use of a password by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users
- Implementing appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement
- Implementing procedures for properly distributing engagement documentation materials to the team members at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement
- Implementing procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation
- Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
    - — Generate scanned copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
    - — Integrate the scanned copies into the engagement files, including indexing and signing off on the copies as necessary.
    - — Enable the scanned copies to be retrieved and printed as necessary.

2.40 *Policy 6: The firm retains engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.* Multioffice CPA Firm implements this policy through the following procedures:

- Establishing procedures that accomplish the following:
    - — Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time.
    - — Provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed.
    - — Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.
- Retaining documentation for a specific period of time as appropriate for the nature of the engagement

2.41 *Policy 7: The firm requires that consultation take place when appropriate; that sufficient and appropriate resources are available to enable appropriate consultation to take place; that all the relevant facts known to the engagement team are provided to those consulted; that the nature, scope, and conclusions of such consultations are documented; and that conclusions resulting from such consultations are implemented.* Multioffice CPA Firm implements this policy through the following procedures:

- Providing personnel with the firm's policies and procedures manual that specifies the firm's consultation policies and procedures. Areas or specialized situations for which the firm requires consultation include the following:
    - — Application of newly issued technical pronouncements.
    - — Industries with special accounting, auditing, or reporting requirements.
    - — Emerging practice problems.
    - — Choices among alternative GAAP 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 date a report was issued.

— Filing requirements of regulators.

— Meetings with regulators at which the firm is to be called upon to support the application of GAAP or GAAS that have been questioned.

— Designating individuals within the firm as consultants in certain areas. Personnel are to consult with the designated individual when issues arise. If differences arise between the engagement partner and the consultant, the matter is to be resolved by the partner(s) responsible for the quality control function.

- Maintaining or providing access to adequate and up-to-date references, which includes materials related to specific industries, specialties, and regulatory requirements, in each office.
- Requiring that documentation of consultation include all relevant facts and circumstances, the sections of the professional literature used in making a determination, the conclusion reached, how the conclusions were implemented, and the signatures of the engagement partner and consultant. This documentation is to be retained with the engagement documentation of the work performed and conclusions reached. At the discretion of the consultant, the documentation may be entered in a retrievable database to promote efficiencies in the consultation process and consistency in the resolution of similar issues.

2.42 *Policy 8: The firm deals with and resolves differences of opinion, documents and implements conclusions reached, and does not release the report until the matter is resolved.* Multioffice CPA Firm implements this policy through the following procedures:

- Requiring that all differences of professional judgment within an engagement team be resolved by the engagement and quality control partners, and the managing partner if necessary, and that the report not be released until the matter is resolved.
- Requiring that the resolution of the differences be appropriately documented. If members of the engagement team continue to disagree with the resolution, they may disassociate themselves from the resolution of the matter and may document that a disagreement continues to exist.

2.43 *Policy 9: The firm has criteria for determining whether an engagement quality control review should be performed; evaluates all engagements against the criteria; performs an engagement quality control review for all engagements that meet the criteria; and completes the review before the report is released.* Multioffice CPA Firm implements this policy by defining high-risk engagements and requiring that an engagement quality control review be performed for all high-risk engagements, engagements for financial institutions, and engagements performed for significant clients.

2.44 *Policy 10: The firm establishes procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.* Multioffice CPA Firm implements this policy through the following procedures:

- Implementing procedures addressing the timing of the review. The firm has concluded that performing an engagement quality control review is not necessary to obtain sufficient appropriate audit evidence for audit engagements; therefore, the engagement quality control review does not need to be completed before the date of the auditor's report but is required to be completed before the report is released. When the engagement quality control review results in additional audit procedures being performed, the date of the auditor's report is changed to the date by which sufficient appropriate audit evidence has been obtained.
- Implementing procedures addressing the nature and extent of the review. The firm's procedures for audit and attestation engagements require that the engagement quality control reviewer do the following:

— Discuss significant accounting, auditing, and financial reporting issues with the engagement partner, including matters for which there has been consultation.

  - Discuss with the engagement partner the engagement team's identification and audit of high-risk assertions, transactions, and account balances.
  - Review selected working papers relating to the significant judgments the engagement team made and the conclusions they reached.
  - Review documentation of the resolution of significant accounting, auditing, and financial reporting issues, including documentation of consultation with firm personnel or external sources.
  - Review the summary of uncorrected misstatements that are related to known and likely misstatements.
  - Review additional engagement documentation to the extent considered necessary.
  - Read the financial statements and report and consider whether the report is appropriate.
  - Confirm with the engagement partner that there are no significant unresolved issues.
  - Complete the review before the release of the report.
  - Determine whether the issues raised in the review indicate a need to change the auditor's report date.
- Resolving conflicting opinions between the engagement partner and the engagement quality control reviewer regarding significant matters. The policy requires documentation of the resolution of conflicting opinions before the release of the audit report.
- Implementing procedures addressing documentation by the engagement quality control reviewer. The firm's procedures require documentation of the following:
  - That the procedures required by the firm's policies on engagement quality control review have been performed
  - That the engagement quality control review has been completed before the report is released
  - That no matters have come to the attention of the engagement quality control reviewer that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate

2.45 *Policy 11: The firm establishes criteria for the eligibility of engagement quality control reviewers.* Multioffice CPA Firm implements this policy by establishing the following criteria for an engagement quality control reviewer:

- Is not selected by the engagement partner
- Has sufficient technical expertise and experience
- Carries out his or her responsibilities with objectivity and due professional care without regard to the relative positions of the engagement partner and the engagement quality control reviewer
- Does not assume any of the responsibilities of the engagement partner or have responsibility for the audit of any significant subsidiaries, divisions, benefit plans, or affiliated or related entities
- Meets the independence requirements relating to the engagements reviewed, even though the engagement quality control reviewer is not a member of the engagement team
- Does not make decisions for the engagement team or participate in the performance of the engagement, except that the engagement partner may consult the engagement quality control reviewer at any stage during the engagement

Monitoring

2.46 The objective of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

2.47 Multioffice CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 2.48–.51.

2.48 *Policy 1: The firm assigns responsibility for the monitoring process to a partner and assigns performance of the monitoring process to competent individuals.* Multioffice CPA Firm implements this policy through the following procedures:

- Designating a partner with appropriate authority to be responsible for quality assurance, including ensuring that the firm's quality control policies and procedures and its methodologies remain relevant and adequate. Factors to be considered include the following:
  - — Mergers and divestitures of portions of the practice
  - — Changes in professional standards and other regulatory requirements applicable to the firm's practice
  - — Results of inspections and peer reviews
  - — Reviews of litigation and regulatory enforcement actions against the firm and others
  - — Changes in applicable AICPA membership requirements
- Preparing inspection checklists and guidance materials or using materials prepared by the AICPA for performing inspection procedures.
- 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 take the following actions:
  - — Revise policies and procedures related to the other elements of quality control because they are ineffective or inappropriately designed
  - — Improve compliance with firm policies and procedures related to the other elements of quality control
- Assigning performance of the monitoring process to the designated quality control individual for each practice office.

2.49 *Policy 2: The firm performs monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.* Multioffice CPA Firm implements this policy through the following procedures:

- Developing and performing the firm's inspection program to obtain feedback about the effectiveness of the firm's policies and procedures.

- Reviewing the resolution of matters reported by professional personnel on independence-confirmation forms to determine that matters have been appropriately considered and resolved.
- Interviewing personnel at all professional management and staff levels to obtain information about operating procedures in practice offices, whether personnel are knowledgeable about firm policies and procedures, and whether such policies and procedures are being effectively communicated.
- Reviewing the following documentation to determine compliance with firm policies and procedures:
  - — Personnel evaluations, including documentation of hiring and advancement decisions
  - — Documentation of client acceptance and continuance decisions
  - — Participants' evaluations of practice office training programs
  - — Professional development records of personnel
  - — Correspondence regarding the resolution of independence matters within the practice office
- Developing a plan to test a sample of engagements for compliance with the firm's policies and procedures. Such a review may be preissuance or postissuance.
- Reviewing a cross-section of engagements from selected practice offices using the following criteria for inclusion in the sample selected:
  - — Engagements involving all partners and managers who have significant accounting and auditing responsibilities in the selected offices
  - — Engagements for financial institutions
  - — First-year engagements
  - — Significant client engagements
  - — Specialized industries, with emphasis given to high-risk industries
  - — Level of service performed (audit, review, compilation, and attestation)
  - — Level of attestation services performed (examination, review, and agreed-upon procedures)
  - — Engagements for which there have been complaints or allegations that the work performed by the firm fails to comply with professional standards, regulatory requirements, or the firm's system of quality control
  - — Engagements in which there were significant disagreements between the quality review partner and the engagement partner
- Periodically reviewing the process for personnel evaluation and counseling to ascertain the following:
  - — Procedures for evaluation and documentation are being followed on a timely basis
  - — Personnel who have been promoted have achieved the applicable requirements for advancement
  - — Personnel decisions are consistent with evaluations
  - — Recognition is given to outstanding performance
- Designating a partner or qualified individual in each office to review the summary of the evaluations of in-house training programs to determine whether the programs are achieving their objectives.

- 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 applicable regulators.
- Interviewing selected professional personnel regarding the effectiveness of training programs.
- Considering the results of the firm's inspection as they relate to the effectiveness of the firm's professional development program.
- Ascertaining whether inquiries received by individuals consulted within the firm indicate the need for additional CPE programs.
- Reviewing and updating firm practice aids, such as audit programs, forms, and checklists, to reflect new or revised professional pronouncements.
- Issuing guidance regarding new professional standards, regulatory requirements, and related changes to firm policy.
- Soliciting comments from partners and managers as to the effectiveness of practice aids and tools.

2.50 *Policy 3: The firm communicates at least annually (a) deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel and (b) the results of the monitoring of its quality control system process to relevant firm personnel.* Multioffice CPA Firm implements this policy through the following procedures:

- Preparing a summary monitoring report for the firm's senior management that evaluates the overall results of the inspection and other monitoring procedures and reaches final conclusions as to whether the firm as a whole needs to improve compliance with the firm's policies and procedures and whether revisions to the firm's quality control policies and procedures are necessary.
- Communicating findings to practice office personnel and determining the corrective actions to be taken for 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.
- Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s).
- Communicating in partner-manager meetings and firm policy correspondence the need for changes in the system of quality control.
- Communicating in training programs, partner-manager meetings, and firm policy correspondence the need for improved compliance with the system of quality control.

2.51 *Policy 4: The firm deals appropriately with complaints and allegations.* Multioffice CPA Firm implements this policy through the following procedures:

- Establishing procedures for concerns to be brought to the attention of the ethics committee in a confidential manner
- Having the firm's ethics committee (excluding any members who are otherwise involved in the engagement under investigation) investigate the following:
  - — Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
  - — Allegations of noncompliance with the firm's system of quality control
  - — Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations
- Consulting with legal counsel as necessary

- Documenting complaints and allegations and the responses to them

2.52 *Policy 5: The firm prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control.* Multioffice CPA Firm implements this policy by designing its summary monitoring report to provide evidence of the operation of each element of its system of quality control, including the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be inspected
- A record of the evaluation of the following:
  - — Adherence to professional standards and regulatory and legal requirements
  - — Whether the quality control system has been appropriately designed and effectively implemented
  - — Whether the firm's quality control policies and procedures have been appropriately applied
- Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be

2.53 *Policy 6: The firm retains documentation providing evidence of the operation of the system of quality control for an appropriate period of time.* Multioffice CPA Firm implements this policy by requiring retention of the summary monitoring report for a period of time sufficient to meet the firm's peer review or other regulatory requirements.

Chapter 3:

System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Firm With a Single Office

3.01 This chapter describes how a CPA firm that has a single office (Single office CPA Firm) implements each element of quality control in its accounting and auditing practice. Single office CPA Firm is a hypothetical firm with 1 office, 3 partners, and a total of 10 professionals. Its accounting and auditing practice has a concentration of employee benefit plans, and the firm has no issuer clients.[1] The firm uses 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.

Quality Control Policies and Procedures

3.02 The firm's system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those polices. The policies and procedures are required to be documented. Single office CPA Firm documents its system of quality control by preparing a document that comprehensively describes the policies and procedures for each element of quality control. Single office CPA Firm reviews the documentation at least annually and updates it as necessary.

3.03 The firm should communicate its quality control policies and procedures to its personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

3.04 Single office CPA Firm communicates these policies and procedures in writing and makes the documentation available electronically to all professional personnel. Single office CPA Firm requires each individual to be familiar with and to comply with these policies and procedures. Single office CPA Firm encourages its personnel to communicate their views or concerns about quality control matters to partners.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

3.05 The objective of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. Single office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 3.06–.10.

3.06 *Policy 1: The firm's managing partner assumes ultimate responsibility for the firm's system of quality control.* Single office CPA Firm implements this policy through the following procedures:

- Having the managing partner accept ultimate responsibility for the firm's system of quality control and for setting a tone that emphasizes the importance of quality and of following the firm's system of quality control
- Informing personnel that failure to adhere to the firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action

3.07 *Policy 2: Commercial considerations do not override the quality of the work performed.* Single office CPA Firm implements this policy through the following procedures:

[1] If Single office CPA Firm were to be engaged to perform audit services for an issuer, it might need to revise its quality control policies and procedures to comply with Public Company Accounting Oversight Board (PCAOB) standards and to reflect Securities and Exchange Commission (SEC) requirements applicable to audits of issuers.

- Having the managing partner continually evaluate client relationships and specific engagements so that commercial considerations do not override the objectives of the system of quality control
- Emphasizing to all personnel that fee considerations and scope of services should not infringe upon quality work

3.08 *Policy 3: Responsibility for developing, implementing, and operating the firm's quality control system is assigned to personnel with sufficient and appropriate experience, authority, and ability.* Single office CPA Firm implements this policy by having the managing partner designate a quality control partner who is responsible for designing, implementing, and monitoring the firm's quality control system.

3.09 *Policy 4: Performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel demonstrate the firm's overarching commitment to the objectives of the system of quality control.* Single office CPA Firm implements this policy through the following procedures:

- Designing and implementing performance evaluation and advancement systems that reward partners and staff involved in the accounting and auditing practice for the quality of their work and their compliance with professional standards.
- Establishing a compensation system that provides incentives to accounting and auditing partners and senior-level employees for the quality of their accounting and auditing work. The compensation system does the following:
    - — Takes into consideration firm feedback based on monitoring results and peer reviews of the work performed
    - — Rewards partners and personnel for timely (*a*) identification of significant and emerging accounting and auditing issues and (*b*) consultation with firm experts

3.10 *Policy 5: The firm devotes sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.* Single office CPA Firm implements this policy through the following procedures:

- Providing the designated quality control partner with sufficient time, authority, and resources to develop, implement, and maintain the firm's quality control policies and procedures
- Providing the firm's quality control documentation to personnel when they are initially hired and reviewing the documentation with them
- Reviewing the firm's quality control policies and procedures with personnel at firm training sessions at least annually

Relevant Ethical Requirements

3.11 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Single office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 3.12–.17.

3.12 *Policy 1: Personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the GAO, and any other applicable regulators.* Single office CPA Firm implements this policy through the following procedures:

- Designating a quality assurance partner to review relevant pronouncements relating to independence, integrity, and objectivity; answer questions; determine the circumstances for which consultation with sources outside the firm is required; and resolve matters
- Providing personnel with access to the AICPA *Professional Standards* service

- Establishing a system for identifying all services performed for each client and evaluating whether any of those services might impair independence

3.13 *Policy 2: The firm establishes procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.* Single office CPA Firm implements this policy through the following procedures:

- Informing personnel of those entities to which independence policies apply by doing the following on a timely basis:
  - Preparing and maintaining a list of entities with which firm personnel are prohibited from having a financial or business relationship
  - Making the list available to personnel so they may evaluate their independence (including personnel new to the firm)
  - Notifying personnel of changes in the list
- Providing frequent reminders of professional responsibilities to personnel, such as avoiding behavior that might be perceived as impairing their independence or objectivity

3.14 *Policy 3: The firm establishes procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.* Single office CPA Firm implements this policy through the following procedures:

- Requiring the engagement partner to consider relevant information about client engagements, including the scope of services, to enable him or her to evaluate the overall impact, if any, on independence requirements
- Accumulating and communicating relevant information to appropriate personnel so that the following can occur:
  - The firm, the engagement partner, and other firm personnel can readily determine whether they satisfy independence requirements.
  - The firm can maintain and update information relating to independence.
  - The firm and the engagement partner can take appropriate action regarding identified threats to independence.
- Requiring personnel to promptly report circumstances and relationships that create a threat to independence, and independence breaches of which they become aware, so that appropriate action can be taken
- Establishing criteria to determine the need for safeguards for engagements where the following have taken place:
  - Monitoring procedures or peer review has identified weaknesses in previous years.
  - The same senior personnel have been used for five years or more on an audit or attestation engagement.
- Promptly communicating identified breaches of these policies and procedures, and the required corrective actions, to the following personnel:
  - The engagement partner who, with the firm, needs to address the breach.
  - Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action.
- Requiring the engagement partner and the other individuals referred to in the previous list to confirm to the firm that the required corrective actions have been taken

- Having a partner, or an individual designated by the partner, periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence
- Establishing additional procedures that provide safeguards when the firm performs audit or other attest work for (*a*) significant clients or (*b*) clients at which partners or other senior personnel are offered key management positions or have accepted offers of employment

3.15 *Policy 4: The firm withdraws from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.* Single office CPA Firm implements this policy through the following procedures:

- Consulting within the firm, and with legal counsel and other parties if necessary, when the firm believes that effective safeguards to reduce threats to independence to an acceptable level cannot be applied
- Withdrawing from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied

3.16 *Policy 5: The firm obtains written confirmation, at least annually, of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant requirements.* Single office CPA Firm implements this policy through the following procedures:

- Obtaining written representations from personnel, upon hire and on an annual basis, stating that they have read the firm's independence, integrity, and objectivity policies, understand the applicability of those policies to their activities, and have complied with the requirements of those policies since their last representation. (Such written representations are accompanied by the most current list of all entities with which firm personnel are prohibited from having a business relationship.)
- Reviewing these independence representations for completeness and resolving reported exceptions.
- Requiring the engagement partner to sign a step in the engagement program attesting to compliance with independence requirements that apply to the engagement.

3.17 *Policy 6: The firm establishes procedures for confirming the independence of another firm that performs part of the engagement.* Single office CPA Firm implements this policy through the following procedures:

- Using practice aids that prescribe the form and content of independence representations, and frequency with which they are to be obtained
- Requiring that such representations be documented

Acceptance and Continuance of Client Relationships and Specific Engagements

3.18 The objective of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;

- is competent to perform the engagement and has the capabilities and resources to do so;
- can comply with legal and ethical requirements; and
- has reached an understanding with the client regarding the services to be performed.

3.19 Single office 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 policies and procedures described in paragraphs 3.20–.24.

3.20 *Policy 1: The firm evaluates factors that have a bearing on management's integrity and considers the risk associated with providing professional services in particular circumstances.* Single office CPA Firm implements this policy through the following procedures:

- Informing personnel of the firm's policies and procedures for accepting and continuing clients, including those outlined in the firm's practice aids.
- Obtaining and evaluating relevant information such as the following before accepting or continuing a client:
  - The nature and purpose of the services to be provided and management's understanding thereof
  - The identity of the client's principal owners, key management, related parties, and those charged with its governance
  - Information obtained from inquiries of the client's bankers, factors, attorneys, credit services, and others who have business relationships with the entity
  - The nature of the client's operations, including its business practices, from sources such as annual reports, interim financial statements, reports to and from regulators, income tax returns, and credit reports
  - Information concerning the attitude of the client's principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting
- Evaluating the risk of providing services for the following engagements:
  - Engagements for entities operating in highly specialized or regulated industries, including financial institutions, governmental entities, and employee benefit plans
  - Engagements that require an inordinate amount of time to complete relative to the available resources of the firm
- Communicating with the predecessor accountant or auditor when required or recommended by professional standards. This communication also includes inquiries regarding the nature of any disagreements and whether there is evidence of opinion-shopping.
- Conducting a background check of the business, its officers, and the person(s) in question by using the services of an investigative company and evaluating the information obtained regarding management's integrity. Background checks are conducted when the firm is unable to obtain sufficient information about the prospective client after taking the steps described previously, or there is an indication that management or someone affiliated with the prospective client may be less than reputable.
- Evaluating the risk of providing services to significant clients or to other clients for which the firm's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (*a*) the amount of time the partner devotes to the engagement, (*b*) the effect on the partner's stature within the firm as a result of his or her service to the client, (*c*) the manner in which

the partner is compensated, and (*d*) the effect that losing the client would have on the partner and the firm.

3.21 *Policy 2: The firm evaluates whether the engagement can be completed with professional competence; undertakes only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluates, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.* Single office CPA Firm implements this policy through the following procedures:

- Evaluating whether the firm has obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements.
- Evaluating whether the following are in place:
  — The firm has sufficient personnel with the necessary capabilities and competence.
  — Specialists are available if needed.
  — Individuals meeting the criteria and eligibility requirements to perform an engagement quality control review are available, when needed.
  — The firm is able to complete the engagement within the reporting deadline.
- Specifying conditions that trigger the requirement to reevaluate a specific client or engagement. The following are examples of such conditions:
  — Significant changes in the client, such as a major change in senior client personnel, ownership, advisers, 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, such as the loss of and inability to replace key personnel who are particularly knowledgeable about a specialized industry.
  — 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.
  — The client's delinquency in paying fees. (This may also affect the firm's independence.)
  — Engagements for entities operating in highly specialized or regulated industries, such as financial institutions, governmental entities, and employee benefit plans.
  — Engagements for entities in which there may be substantial doubt about the entity's ability to continue as a going concern.
  — Engagements in which the client has ignored prior recommendations, such as those that address deficiencies in internal control.
- Obtaining relevant information to determine whether the relationship should be continued and establishing a frequency for evaluations (for example, continuance decisions are made at least annually).
- Evaluating the information obtained regarding acceptance or continuance of the client or engagement through the following activities:

  a. The engagement partner assesses the information obtained about the client or the specific engagement, including information about the significance of the client to the firm, and makes a recommendation about whether the client or engagement should be accepted or continued.

  b. The engagement partner completes a client acceptance form and submits it to the managing partner for approval.

c. The engagement partner signs a step in the planning program noting consideration of client continuance and completes a form documenting the rationale and conclusion regarding client continuance if conditions exist that trigger the requirement to reevaluate a client or engagement between annual audits.

d. The managing partner assesses and approves the recommendation made by the engagement partner. If the managing partner recommends not accepting a client or discontinuing a client relationship, the managing partner discusses his or her reasons for the acceptance or continuance decision with the other partners.

- Establishing procedures for dealing with information that would have caused the firm to decline the engagement if the information had been available earlier.

3.22 *Policy 3: The firm obtains an understanding with the client regarding the services to be performed.* Single office CPA Firm implements this policy by requiring that, for all engagements, the firm prepare a written engagement letter documenting the understanding with the client and obtain the client's signature on that letter, thus minimizing the risk of misunderstanding regarding the nature, scope, and limitations of the services to be performed.

3.23 *Policy 4: The firm establishes procedures on withdrawal from an engagement or from both the engagement and the client relationship.* Single office CPA Firm implements this policy through the following procedures:

- Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances
- Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place or for the firm to report to regulatory authorities the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal
- Discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship if the firm determines that it is appropriate to withdraw

3.24 *Policy 5: The firm documents how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.* Single office CPA Firm implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

Human Resources

3.25 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Single office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 3.26–.32.

3.26 *Policy 1: Personnel who are hired possess the characteristics that enable them to perform competently.* Single office CPA Firm implements this policy through the following procedures:

- Designating an individual in the firm to be responsible for the following activities:
  - Managing the human resources function
  - Evaluating the firm's personnel needs by considering factors such as existing clientele, anticipated growth, personnel turnover, and individual advancement
  - Developing criteria for determining which individuals will be involved in the interviewing and hiring process

- Establishing an understanding among the partners about the attributes, achievements, and experiences desired in entry-level and experienced personnel
- Setting guidelines for the additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions

3.27 *Policy 2: The firm determines capabilities and competencies required for an engagement, including those required of the engagement partner.* Single office CPA Firm implements this policy by specifying the competencies that the engagement partners of the firm's accounting, auditing, and attestation engagements (or other persons responsible for supervising and signing or authorizing someone to sign the firm's report on such engagements) should possess. These competencies include having an understanding of the following:

- The role of the firm's system of quality control and the AICPA Code of Professional Conduct in ensuring the integrity of the accounting, auditing, and attest functions to users of reports.
- The performance, supervision, and reporting aspects of the engagement, which ordinarily are gained through training or participation in similar engagements.
- The industry in which the client operates, including its organization and operating characteristics, sufficient to identify areas of high or unusual risk associated with the engagement and to evaluate the reasonableness of industry-specific estimates.
- The professional standards applicable to the engagement and the industry in which the client operates. Such standards include accounting, auditing, and attestation standards, as well as rules and regulations issued by applicable regulators.
- The skills that contribute to sound professional judgment, including the ability to exercise professional skepticism.
- How the organization uses information technology and the manner in which information systems are used to record and maintain financial information.

3.28 *Policy 3: The firm determines the capabilities and competencies possessed by personnel.* Single office CPA Firm implements this policy through the following procedures:

- Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation
- Evaluating personnel at least annually to determine their capabilities and competencies

3.29 *Policy 4: The firm assigns the responsibility for each engagement to an engagement partner.* Single office CPA Firm implements this policy through the following procedures:

- Assigning responsibility for each engagement to an engagement partner who has the appropriate capabilities, competence, authority, and time to perform the role
- Clearly defining and communicating the responsibilities of the partner to the engagement partner
- Communicating the identity and role of the partner to management and those charged with governance
- Monitoring the workload and availability of engagement partners to enable these individuals to have sufficient time to adequately discharge their responsibilities

3.30 *Policy 5: The firm assigns personnel (including partners) based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.* Single office CPA Firm implements this policy through the following procedures:

- Designating an appropriate person to be responsible for assigning personnel to engagements based on such factors as the following:
    - — Engagement type, size, significance, complexity, and risk profile

— Specialized experience and expertise required for the engagement and competencies gained through prior experience

— Personnel availability

— Timing of the work to be performed

— Continuity and rotation of personnel

— Opportunities for on-the-job training

— Situations for which independence or objectivity concerns exist

- Designating a partner to be responsible for partner and manager assignments
- Requiring approval of partner and manager assignments from the managing partner or other partner in the case of high-risk or significant client engagements

3.31 *Policy 6: Personnel participate in general and industry-specific continuing professional education (CPE) and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state boards of accountancy, and other regulators.* Single office CPA Firm implements this policy through the following procedures:

- Encouraging personnel to pass the Uniform CPA Examination
- Assigning responsibility to a partner to maintain a professional development program that does the following:

  — Requires personnel to participate in professional development programs in accordance with firm guidelines and in subjects that are relevant to their responsibilities

  — Takes into account the requirements of the AICPA, state boards of accountancy, and other regulatory agencies in establishing the firm's CPE requirements

  — Provides CPE course materials to, and maintains records of completed CPE for, professional personnel

  — Provides an orientation and training program for new hires

- Encouraging participation by personnel at each level in the firm in other professional development activities such as completing external professional development programs, including graduate-level and self-study courses, becoming members of professional organizations, serving on professional committees, writing for professional publications, and speaking to professional groups
- Communicating and distributing to personnel, when applicable, changes in accounting, auditing, attestation, and quality control standards, as well as independence requirements and the firm's guidance with respect to those standards and requirements

3.32 *Policy 7: Personnel selected for advancement have the qualifications to fulfill the responsibilities they will be called on to assume.* Single office CPA Firm implements this policy through the following procedures:

- Assigning responsibility to the three partners to jointly make advancement and termination decisions. Such responsibilities include the following:

  — Establishing criteria for evaluating personnel at each professional level and for advancement to the next higher level of responsibility. Such criteria give recognition and reward to the development and maintenance of competence and commitment to ethical principles.

  — Informing firm personnel about the criteria for advancement to the next higher level of responsibility.

  — Designating personnel responsible for preparing evaluations and determining when they should be prepared.

- — Informing personnel that failure to adhere to the firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action.
- — Using forms that include the applicable qualifications when evaluating the performance of personnel. Such forms include qualifications related to performance quality and adherence to ethical principles.
- — Reviewing evaluations on a timely basis with the individual being evaluated.

- Counseling personnel regarding their progress and career opportunities by doing the following:
  - — Evaluating employees annually and at the end of each assignment lasting four weeks or longer to provide feedback on performance.
  - — Summarizing and reviewing with personnel annually the evaluation of their performance, including an assessment of their progress with the firm. Considerations include past performance, future objectives of the individual and the firm, the individual's assignment preferences, and career opportunities.
  - — Evaluating partners periodically by means of counseling, peer evaluation, or self-appraisal, as appropriate.

Engagement Performance

3.33 The objective of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (*b*) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. Single office CPA Firm satisfies these objectives by establishing and maintaining the policies and procedures described in paragraphs 3.34–.44.

3.34 *Policy 1: Planning for engagements meets professional, regulatory, and the firm's requirements.* Single office CPA Firm implements this policy by maintaining and providing personnel with the firm's practice aids that prescribe the factors the engagement team should consider in the planning process and the extent of documentation of those considerations. Planning considerations may vary depending on the size and complexity of the engagement. Planning generally includes the following activities:

- Assigning responsibilities to appropriate personnel during the planning phase
- Developing or updating background information on theclient and the engagement
- Considering client significance to the firm
- Developing a planning document that includes the following:
  - — Proposed work programs tailored to the specific engagement
  - — Staffing requirements and the need for specialized knowledge
  - — Consideration of the economic conditions affecting the client and its industry and their potential effect on the conduct of the engagement
  - — The risks, including fraud considerations, affecting the client and the engagement and how the risks may affect the procedures performed
  - — A budget that allocates sufficient time for the engagement to be performed in accordance with professional standards and the firm's quality control policies and procedures

3.35 *Policy 2: The engagement is performed, supervised, documented, and reported (or communicated) in accordance with the requirements of professional standards, applicable regulators, and the firm.* Single office CPA Firm implements this policy through the following procedures:

- Providing adequate supervision during the course of an engagement, including briefing the engagement team on the objectives of their work. The training, ability, and experience of the personnel are considered when assigning supervisors to the engagement.
- Requiring that a written work program be used in all engagements.
- Addressing significant issues arising during the engagement, considering their significance, and appropriately modifying the planned approach.
- Adhering to the guidelines set forth by the firm for the form and content of documentation of the work performed and conclusions reached. Such documentation includes standardized forms, checklists, and questionnaires used in the performance of engagements and explanations, when required, of how the firm integrates such aids into engagements.
- Requiring engagement documentation in accordance with professional standards, applicable regulatory requirements, and the firm's policies.

3.36 *Policy 3: Qualified engagement team members review work performed by other team members on a timely basis.* Single office CPA Firm implements this policy by adhering to the following guidelines established by the firm regarding review of the documentation of the work performed and conclusions reached, the financial statements and reports, and documentation of the review process:

- All reviewers are to have appropriate experience, competence, and responsibility.
- For each engagement, there is to be evidence of appropriate review of documentation of the work performed and conclusions reached, the financial statements, and the report.
- Engagement documentation is reviewed to determine whether the following have occurred:
  - The work has been performed in accordance with professional standards and regulatory and legal requirements.
  - Significant findings and issues have been raised for further consideration.
  - Appropriate consultations have taken place, and the resulting conclusions have been documented and implemented.
  - The nature, timing, and extent of work performed are appropriate and do not need revision.
  - The work performed supports the conclusions reached and is appropriately documented.
  - The evidence obtained is sufficient and appropriate to support the report.
  - The objectives of the engagement procedures have been achieved.

3.37 *Policy 4: Engagement teams complete the assembly of final engagement files on a timely basis.* Single office CPA Firm implements this policy by completing the assembly of final engagement files in accordance with professional standards and applicable regulatory requirements, if any.

3.38 *Policy 5: The firm maintains the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.* Single office CPA Firm implements this policy through the following procedures:

- Establishing and applying controls to accomplish the following:
  - Clearly determine when and by whom engagement documentation was prepared and reviewed.

   — Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means.
   — Prevent unauthorized changes to the engagement documentation.
   — Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

- Implementing procedures for properly distributing engagement documentation materials to engagement teams at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement
- Implementing procedures to restrict access to, and enable proper distribution and confidential storage of, hardcopy engagement documentation
- Requiring the use of passwords by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users
- Implementing appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement
- Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
   — Generate copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
   — Integrate the copies into the engagement files, including indexing and signing off on the copies as necessary.
   — Enable the copies to be retrieved and printed as necessary.

3.39 *Policy 6: The firm retains engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.* Single office CPA Firm implements this policy through the following procedures:

- Retaining engagement documentation for a period of time sufficient to meet the requirements of the state board of accountancy and applicable professional standards
- Establishing procedures that
   — enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time;
   — provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed; and
   — enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

3.40 *Policy 7: The firm requires that consultation take place when appropriate; that sufficient and appropriate resources are available to enable appropriate consultation to take place; that all the relevant facts known to the engagement team are provided to those consulted; that the nature, scope, and conclusions of such consultations are documented; and that conclusions resulting from such consultations are implemented.* Single office CPA Firm implements this policy through the following procedures:

- Consulting with those having appropriate knowledge, authority, and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical, and other matters. Single office CPA firm uses advisory services provided by other firms, professional and regulatory bodies, and commercial organizations that provide relevant quality control services. Before using such services, the firm evaluates whether the external provider is qualified for that purpose.

- Informing personnel of the firm's consultation policies and procedures.
- Requiring sufficiently experienced engagement team members to identify matters for consultation or consideration during the engagement.
- Requiring consultation in specialized areas or situations with appropriate individuals within and outside the firm when matters such as the following arise:
    - — The 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 date a report was issued
    - — Filing requirements of regulators
    - — Meetings with regulators at which the firm is to be called on to support the application of generally accepted accounting principles or generally accepted auditing standards that have been questioned
- Providing all professional personnel with access to adequate and current reference materials.
- Including all relevant facts, circumstances, the professional literature used, and conclusions reached in the engagement documentation of the work performed and conclusions reached.
- Documenting the issue on which consultation was sought and the results of the consultation, including any decisions taken, the basis for those decisions, and how they were implemented. If there is an unresolved disagreement, an outside source may be consulted to assist in determining the appropriate application of accounting principles.

3.41 *Policy 8: The firm deals with and resolves differences of opinion, documents and implements conclusions reached, and does not release the report until the matter is resolved.* Single office CPA Firm implements this policy through the following procedures:

- Requiring that all differences of professional judgment among members of an engagement team be resolved by the engagement and the quality control partners, and the managing partner if necessary, and that the report not be released until the matter is resolved.
- Requiring that conclusions reached be appropriately documented. If members of the team continues to disagree with the resolution, they may disassociate themselves from the resolution of the matter and may document that a disagreement continues to exist.

3.42 *Policy 9: The firm has criteria for determining whether an engagement quality control review should be performed, evaluates all engagements against the criteria, performs an engagement quality control review for all engagements that meet the criteria, and completes the review before the report is released.* Single office CPA Firm implements this policy through the following procedures:

- Establishing criteria such as the following:
    - — The identification of unusual circumstances or risks in an engagement or class of engagements as determined by the engagement partner or quality control partner.
    - — An engagement quality control review is required by law or regulation.
- Evaluating all engagements against the criteria
- Performing an engagement quality control review for all engagements that meet the criteria

3.43 *Policy 10: The firm establishes procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.* Single office CPA Firm implements this policy through the following procedures:

- Implementing procedures addressing the nature, timing, and extent of the review. The firm has concluded that performing an engagement quality control review is not necessary to obtain sufficient appropriate audit evidence for audit engagements; therefore, the engagement quality control review does not need to be completed before the date of the auditor's report. When the engagement quality control review results in additional audit procedures being performed, the date of the auditor's report is changed to the date by which sufficient appropriate audit evidence has been obtained. The firm's procedures require that for audit and attestation engagements, the engagement quality control reviewer do the following:
    - Discuss significant accounting, auditing, and financial reporting issues with the engagement partner, including matters for which there has been consultation.
    - Discuss with the engagement partner the engagement team's identification and audit of high-risk assertions, transactions and account balances.
    - Confirm with the engagement partner that there are no significant unresolved issues.
    - Review selected working papers relating to the significant judgments the engagement team made and the conclusions they reached.
    - Review documentation of the resolution of significant accounting, auditing, or financial reporting issues, including documentation of consultation with firm personnel or external sources.
    - Review the summary of uncorrected misstatements related to known and likely misstatements.
    - Review additional engagement documentation to the extent considered necessary.
    - Read the financial statements and the report and consider whether the report is appropriate.
    - Complete the review before the release of the report. The review may be conducted at appropriate stages during the engagement.
    - Determine whether the issues raised in the review indicate a need to change the auditor's report date.
- Resolving conflicting opinions between the engagement partner and the engagement quality control reviewer regarding significant matters. The policy requires documentation of the resolution of conflicting opinions before the release of the audit report.
- Implementing procedures addressing documentation by the engagement quality control reviewer. The firm's procedures require documentation of the following:
    - The procedures required by the firm's policies on engagement quality control review have been performed.
    - The engagement quality control review has been completed before the report is released.
    - No matters have come to the attention of the engagement quality control reviewer that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

3.44 *Policy 11: The firm establishes criteria for the eligibility of engagement quality control reviewers.* Single office CPA Firm implements this policy by establishing the following criteria for an engagement quality control reviewer:

- Is selected by the quality control partner or the managing partner

- Has sufficient technical expertise and experience
- Carries out his or her responsibilities with objectivity and due professional care without regard to the relative positions of the audit engagement partner and the engagement quality control reviewer
- Meets the independence requirements relating to the engagements reviewed, even though the engagement quality control reviewer is not a member of the engagement team
- Does not make decisions for the engagement team or participate in the performance of the engagement except that the engagement partner may consult the engagement quality control reviewer at any stage during the engagement

When the firm does not have suitably qualified personnel to perform the engagement quality control review, the firm contracts with a suitably qualified external person to perform the engagement quality control review.

Monitoring

3.45 The objective of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

3.46 Single office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 3.47–.56.

3.47 *Policy 1: The firm assigns responsibility for the monitoring process, including performance, to a partner or competent individual.* Single office CPA Firm implements this policy through the following procedures:

- Designating a partner or senior personnel to be responsible for quality assurance, including ensuring that the firm's quality control policies and procedures and its methodologies remain relevant and adequate. Factors to be considered include the following:
  - — Mergers and divestitures of portions of the practice
  - — Changes in professional standards or other regulatory requirements applicable to the firm's practice
  - — Results of inspections and peer reviews
  - — Review of litigation and regulatory enforcement actions against the firm and its personnel
  - — 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 do the following:
  - — Revise policies and procedures related to the other elements of quality control because they are ineffective or inappropriately designed.
  - — Improve compliance with firm policies and procedures related to the other elements of quality control.

3.48 *Policy 2: The firm performs monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.*

3.49 For purposes of illustrating Policy 2, two scenarios are described. Scenario 1 illustrates how Single office CPA Firm would satisfy the objective of Policy 2 by reviewing engagements throughout the year. Scenario 2 illustrates how Single office CPA Firm would implement Policy 2 by performing an annual inspection, thereby reviewing engagements during a designated period in the year.

3.50 *Scenario 1: Monitoring by Reviewing Engagements Throughout the Year.* Single office CPA Firm implements Policy 2 through the following procedures:

- Designating a partner or management-level individual not previously associated with the engagement to perform either a preissuance or postissuance review of the engagement.
- Establishing the approach for performing preissuance or postissuance reviews, for example, the comprehensiveness of the review and the frequency for summarizing findings (such as monthly or quarterly). The comprehensiveness of the review of selected engagements is similar to that performed in an inspection or peer review.
- Designating the forms and checklists to be used during the engagement and functional element reviews and the extent of the documentation required. (Examples of functional elements are the human resources function and the firm's library.)
- Selecting a cross-section of engagements at the beginning of the monitoring year for preissuance or postissuance review and reevaluating that selection throughout the year as circumstances dictate. Criteria used for selecting engagements include the following:
    - — Significant specialized industries with emphasis on high-risk engagements
    - — Audits of the financial statements of employee benefit plans
    - — First-year engagements
    - — Significant client engagements
    - — Level of service performed (that is, audit and attest, review, or compilation)
    - — Engagements performed by all partners and other management-level personnel having accounting and auditing responsibilities
    - — Engagements performed under *Government Auditing Standards* (Yellow Book engagements)
    - — Engagements for which there have been complaints or allegations from firm personnel, clients, or other third parties that the work performed by the firm failed to comply with professional standards, regulatory requirements, or the firm's system of quality control
    - — Engagements in which there were significant disagreements between the review partner and the engagement partner
- Reviewing the selected engagements. Deficiencies identified as a result of this process are summarized and evaluated to determine whether the following are necessary:
    - — Additional emphasis on specific areas or industries in future engagements
    - — Modifications to existing policies and procedures to prevent the deficiencies noted from recurring
- Reviewing other engagement files at least annually for compliance with the firm's quality control policies and procedures including reviewing correspondence regarding consultation on independence, integrity, and objectivity matters (for example, assessments of significant clients) and acceptance and continuance decisions.

- Reviewing the resolution of matters reported by professional personnel regarding independence to determine that matters have been appropriately considered and resolved.
- Preparing a summary of the deficiencies noted resulting from the preissuance and postissuance reviews so that the partner may incorporate any recommended changes into the firm's policies and procedures.
- Communicating to all professional personnel the deficiencies noted and related changes in quality control procedures.
- Following up on planned corrective actions to determine whether the actions were taken as planned and whether they achieved the intended objectives.

3.51 *Scenario 2: Monitoring by Inspecting a Sample of Engagements During a Designated Period of the Year.* Single office CPA Firm implements Policy 2 through the following procedures:

- 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 in selecting engagements:
    - — Significant specialized industries with emphasis on high-risk engagements
    - — Audits of the financial statements of employee benefit plans
    - — First-year engagements
    - — Significant client engagements
    - — Level of service performed (that is, audit and attest, review, or compilation)
    - — Engagements performed by all partners and other management-level personnel having accounting and auditing responsibilities
    - — Engagements performed under *Government Auditing Standards* (Yellow Book engagements)
    - — Engagements for which there have been complaints or allegations from firm personnel, clients, or other third parties that the work performed by the firm failed to comply with professional standards, regulatory requirements, or the firm's system of quality control
    - — Engagements in which there were significant disagreements between the quality review partner and the engagement partner
- Establishing an approach and timetable for performing the inspection procedures and determining the forms and checklists to be used during the inspection and the extent of documentation required.
- Deciding how long to retain detailed inspection documentation (as opposed to summaries).
- Reviewing correspondence regarding consultation on independence, integrity, and objectivity matters and acceptance and continuance decisions.
- Reviewing the resolution of matters reported by professional personnel regarding independence to determine that matters have been appropriately considered and resolved.
- Selecting a sample of engagements for review to determine compliance with the firm's quality control policies and procedures, reevaluating that selection throughout the process, and reviewing the selected engagements.
- Preparing a summary inspection report for the partner or management group that evaluates the overall results of the inspection and sets forth any recommended changes that should be made to the firm's policies and procedures.
- Reviewing the recommended corrective actions and reaching final conclusions about the actions to be taken.
- Communicating inspection findings and quality control changes to all professional personnel.

- Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s).

3.52 In addition to the procedures described under Scenarios 1 or 2, Single office CPA Firm also implements Policy 2 through the following procedures:

- Reviewing and evaluating firm practice aids, such as audit programs, forms, and checklists, and considering whether they reflect recent professional pronouncements
- Providing information during staff meetings regarding new professional standards, regulatory requirements, and the related changes that should be made to firm practice aids
- Reviewing, or designating a management-level individual to be responsible for reviewing, the professional development policies and procedures to determine whether they are appropriate, effective, and meet the needs of the firm
- Reviewing, or designating a management-level individual to review summaries of the CPE records of the firm's professional personnel to evaluate each individual's compliance with the requirements of the AICPA and other applicable regulators
- Reviewing other administrative and personnel records pertaining to the quality control elements
- Soliciting information from the firm's personnel during staff meetings regarding the effectiveness of training programs

3.53 *Policy 3: The firm communicates (a) deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel and (b) the results of the monitoring of its quality control system process to relevant firm personnel at least annually.* Single office CPA Firm implements this policy through the following procedures:

- Preparing a summary report for the partners that evaluates the overall results of the monitoring and sets forth any recommended changes that should be made to the firm's policies and procedures
- Reviewing the recommended corrective actions and reaching final conclusions as to the actions to be taken
- Communicating to all professional personnel the deficiencies noted and the related changes in quality control procedures
- Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s)

3.54 *Policy 4: The firm deals appropriately with complaints and allegations.* Single office CPA Firm implements this policy through the following procedures:

- Having the managing partner inform personnel that they may raise any concerns regarding complaints or allegations about noncompliance with professional standards, regulatory and legal requirements, or the firm's system of quality control with any partner without fear of reprisals.
- Having a partner who is not otherwise involved in the engagement investigate the following:
  - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
  - Allegations of noncompliance with the firm's system of quality control
  - Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations
- Documenting complaints and allegations and the responses to them.

3.55 *Policy 5: The firm prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control.* Single office CPA Firm implements this policy by designing its summary monitoring report to provide evidence of the operation of each element of its system of quality control, including the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be inspected
- A record of the evaluation of the following:
  - Adherence to professional standards and regulatory and legal requirements
  - Whether the quality control system has been appropriately designed and effectively implemented
  - Whether the firm's quality control policies and procedures have been appropriately applied so that reports that are issued by the firm or engagement partners are appropriate in the circumstances
- Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be

3.56 *Policy 6: The firm retains documentation providing evidence of the operation of the system of quality control for an appropriate period of time*. Single office CPA Firm implements this policy by requiring retention of the summary monitoring report for a period of time sufficient to meet the firm's peer review or other regulatory requirements.

Chapter 4:

System of Quality Control for a CPA Firm's Accounting Practice—Sole Practitioner

4.01 This chapter describes how a sole practitioner (Sole Practitioner, CPA) implements each element of quality control in her accounting practice. Sole Practitioner, CPA, is a hypothetical firm of which Sole Practitioner, CPA, is the sole owner. The firm has no professional staff; however, on occasion Sole Practitioner, CPA, hires per-diem professionals. Her accounting practice consists only of engagements subject to SSARSs. She uses practice aids that have been subjected to peer review in accordance with standards established by the AICPA. Sole Practitioner, CPA, uses per-diem personnel to assist her and recognizes that her policies and procedures would have to change if she were to perform audit or attest engagements or hire full-time or part-time professional staff.

Quality Control Policies and Procedures

4.02 The firm's system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The policies and procedures are required to be documented. Sole Practitioner, CPA, documents her system of quality control by filling out checklists and questionnaires such as those included in the AICPA Peer Review Program Manual. Sole Practitioner, CPA, reviews the documentation at least annually and updates it as necessary.

4.03 The firm should communicate its quality control policies and procedures to its personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

4.04 Sole Practitioner, CPA, meets this requirement with regard to herself by annually reviewing the checklists and questionnaires used to document each element of her system of quality control. Sole Practitioner, CPA, communicates her policies and procedures to per-diem professionals when they are initially contracted for an engagement by holding a discussion with them and follows up on individual engagements. Sole Practitioner, CPA, requires per-diem personnel to be familiar with and to comply with these policies and procedures.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

4.05 The objective of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 4.06–.08.

4.06 *Policy 1: I am ultimately responsible for the firm's system of quality control.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Accepting responsibility for the firm's system of quality control
- Educating herself about requirements for a system of quality control
- Designing and implementing policies and procedures required for her firm's system of quality control

4.07 *Policy 2: Commercial considerations do not override the quality of the work performed.* Sole Practitioner, CPA, implements this policy by continually evaluating client relationships and specific engagements so that commercial considerations do not override the objectives of the system of quality control.

4.08 *Policy 3: I devote sufficient and appropriate resources for the development, communication, and support of the firm's quality control policies and procedures.* Sole Practitioner, CPA, implements this policy by reviewing and updating the quality control policies, procedures, and documentation on an annual basis.

Relevant Ethical Requirements

4.09 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 4.10–.13.

4.10 *Policy 1: I adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the GAO, and any other applicable regulators.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Subscribing to the AICPA *Professional Standards* service.
- Consulting the AICPA Web site for information about changes in professional ethics and independence standards.
- Reviewing unpaid client fees to ascertain whether any outstanding amounts impair the firm's independence.
- Reviewing relevant pronouncements published in the *Journal of Accountancy* relating to independence, integrity, and objectivity and retaining relevant issues of the *Journal of Accountancy*.
- Attending periodic professional training in ethics and independence.
- Complying with SSARSs by disclosing in the accountant's compilation report instances in which the firm is not independent.
- Considering the significance of each client to the firm. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (*a*) the amount of time the partner devotes to the engagement and (*b*) the effect that losing the client would have on the firm.

4.11 *Policy 2: I communicate independence requirements to per-diem professionals.* Sole Practitioner, CPA, implements this policy by making per-diem personnel aware of financial, family, business, and other relationships that may be prohibited by applicable requirements.

4.12 *Policy 3: I establish procedures to identify and evaluate possible threats to independence and objectivity and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards. I withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Considering relevant information about client engagements, including the scope of services, to enable her to evaluate the overall impact on independence
- Consulting with AICPA Ethics Hotline with concerns about possible threats to independence
- Accumulating and communicating relevant information to per-diem personnel as appropriate so that the following can occur:
    - Sole Practitioner, CPA, and per-diem personnel can readily determine whether they satisfy independence requirements.
    - Sole Practitioner, CPA, can maintain and update information relating to independence.
    - Sole Practitioner, CPA, can take appropriate action regarding identified threats to independence.

- Requiring per-diem personnel to promptly notify her of independence breaches of which they become aware, and circumstances and relationships that create a threat to independence, so that appropriate action can be taken
- Documenting any safeguards applied to eliminate threats to independence or reduce them to an acceptable level
- Withdrawing from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied

4.13 *Policy 4: I confirm, in writing, my compliance with policies and procedures on independence and require written confirmation from all per-diem professionals required to be independent by relevant requirements.* Sole Practitioner, CPA, implements this policy by signing a step on each engagement program attesting to her independence and requiring per-diem personnel to do the same.

Acceptance and Continuance of Client Relationships and Specific Engagements

4.14 The objective of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it:

- has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
- is competent to perform the engagement and has the capabilities and resources to do so;
- can comply with legal and ethical requirements; and
- has reached an understanding with the client regarding the services to be performed.

4.15 Sole Practitioner, 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 policies and procedures described in paragraphs 4.16–.20.

4.16 *Policy 1: I evaluate factors that have a bearing on management's integrity and consider the risk associated with providing professional services in particular circumstances.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Obtaining information such as the following before accepting or continuing a client:
  - The nature and purpose of the services to be provided
  - The identity of the client's principal owners, key management, related parties, and those charged with its governance
  - The nature of the client's operations, including its business practices, from sources such as prior-year reports, internally generated financial statements (if applicable), income tax returns, and credit reports
  - Information concerning the attitude of the client's principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting

- Inquiring of third parties such as bankers, factors, and legal counsel about management's business reputation and integrity.
- Communicating with the predecessor accountant when required or suggested by professional standards.[1]
- Evaluating the information obtained regarding management's integrity.
- Evaluating the risk of providing review services to significant clients or to other clients for which Sole Practitioner's, CPA, objectivity or the appearance of independence may be impaired. In determining the significance of a client, Sole Practitioner, CPA, considers the amount of time she devotes to the engagement and the effect that losing the client would have on her practice.

4.17 *Policy 2: I evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Establishing a cut-off date by which evaluations of engagements should be performed, for example, before work on the current-year engagement begins
- Considering conditions, such as the following, that require reevaluation of a client or specific engagement and obtaining the relevant information to determine whether the relationship should be continued:
  — Significant changes in the client, for example, a major change in ownership, senior client personnel, directors, advisers, 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.
  — Client significance.
  — Matters that would have caused the firm to reject the client or engagement had such conditions existed at the time of the initial acceptance. If such matters exist, Sole Practitioner, CPA, considers the professional and legal responsibilities that apply to the circumstances and the possibility of withdrawing from the engagement or both the engagement and the client relationship.
  — The client's delinquency in paying fees. (This also may affect the firm's independence.)
- Determining if she has, or can reasonably obtain, the knowledge and expertise to perform the engagement
- Evaluating the information obtained regarding the engagement, making the acceptance or continuance decision, and documenting her evaluation or conclusion in a memorandum or by signing off next to the relevant item in a practice aid

4.18 *Policy 3: I obtain an understanding with the client regarding the services to be performed.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Adhering to all requirements set forth in professional standards regarding obtaining an understanding with the client
- Requiring that the understanding with the client be documented either through an engagement letter or in a memorandum

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[1] AR section 400, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*, vol. 2), provides guidance on communications between a predecessor and successor accountant when the successor accountant decides to communicate with the predecessor accountant. It also requires a successor accountant who becomes aware of information that leads him or her to believe the financial statements reported on by the predecessor accountant may require revision to request that the client communicate this information to the predecessor accountant.

4.19 *Policy 4: I follow established procedures on withdrawal from an engagement or from both the engagement and the client relationship.* Sole Practitioner, CPA, implements this policy by discussing the issues and her conclusion with the appropriate level of the client's management and those charged with its governance. If she considers it necessary, she also discusses her decision with her attorney.

4.20 *Policy 5: I document how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.* Sole Practitioner, CPA, implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

Human Resources

4.21 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 4.22–.23.

4.22 *Policy 1: I hire per-diem personnel of integrity who possess the characteristics that enable them to perform competently.* Sole Practitioner, CPA, implements this policy by setting criteria, regarding such factors as education, certification or licensure, and experience, that per-diem personnel must meet to be hired.

4.23 *Policy 2: I maintain the knowledge, skills, and abilities required in the circumstances by participating in general and industry-specific continuing professional education (CPE) and professional development activities that enable me to accomplish my responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state boards of accountancy, and other applicable regulators. I also monitor the compliance of per-diem employees with CPE requirements.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Maintaining the competencies necessary to accomplish responsibilities related to each of the firm's engagements
- Establishing a professional development program that takes into account the requirements of the AICPA and state boards of accountancy
- Participating in external professional development programs, including graduate-level and self-study courses
- Joining and becoming an active member of professional organizations
- Serving on professional committees, writing for professional publications on topics she is knowledgeable about, and participating in other professional activities
- Considering changes in the applicable professional standards when determining her professional development program
- Setting criteria that per-diem personnel must meet to competently perform engagements, such as the following examples:
  - Determining that per-diem personnel are in compliance with the applicable professional education requirements of the AICPA, state boards of accountancy, and state CPA societies
  - Obtaining and retaining documentation of such compliance
- Evaluating the knowledge and expertise required to perform an engagement prior to accepting the client or engagement
- Reading professional publications, such as state society journals, to keep abreast of changes in accounting standards and any industry-specific pronouncements that affect the client
- Consulting the AICPA Web site for information about changes in professional standards

Engagement Performance

4.24 The objective of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (*b*) that the firm or the practitioner-in-charge issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. Sole Practitioner, CPA, satisfies these objectives by establishing and maintaining the policies and procedures described in paragraphs 4.25–.32.

4.25 *Policy 1: I plan engagements to meet professional standards, regulatory requirements, and the firm's requirements.* Sole Practitioner, CPA, implements this policy by adhering to professional standards regarding the planning process and the extent of documentation of the planning, if applicable. Engagement planning considerations may include the following:

- Developing or updating client information.
- Assessing the significance of the client to her firm.
- Obtaining an engagement letter for engagements performed under SSARSs. AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), requires the accountant to either issue a compilation report or document an understanding with the entity through the use of an engagement letter when the accountant submits financial statements to a client that are not expected to be used by a third party.
- Reviewing prior financial statements and accountants' reports.
- Using work programs and applicable reporting and disclosure checklists.

4.26 *Policy 2: I perform, supervise, review, document, and report (or communicate) in accordance with the requirements of professional standards.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Requiring the use of appropriate practice aids in all engagements
- Maintaining the availability of current practice aids and AICPA professional standards
- Briefing per-diem personnel on the engagement so that they understand the objectives of their work
- Documenting the work performed in accordance with professional standards and the firm's policy
- Supervising per-diem personnel as appropriate based on the following:
    - Understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation
    - Understanding of professional standards and regulatory and legal requirements
    - Technical knowledge, including knowledge of relevant information technology
    - Knowledge of relevant industries in which the client operates
    - Ability to apply professional judgment
    - Understanding of the firm's quality control policies and procedures
    - Experience level
- Reviewing and initialing all engagement documentation prepared by per-diem personnel

4.27 *Policy 3: I complete the assembly of final engagement files on a timely basis.* Sole Practitioner, CPA, implements this policy by completing the assembly of final engagement files on a timely basis in accordance with professional standards and applicable regulatory requirements, if any.

4.28 *Policy 4: I maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Establishing and applying controls to do the following:
  - Clearly determine when and by whom engagement documentation was prepared and reviewed.
  - Protect the integrity of the information at all stages of the engagement.
  - Prevent unauthorized changes to the engagement documentation.
  - Allow access to the engagement documentation by per-diem personnel and other authorized parties as necessary to properly discharge their responsibilities.
- Tracking the distribution of engagement documentation materials to the per-diem personnel at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement
- Restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation
- Using passwords or data encryption, or both, to restrict access to electronic engagement documentation to authorized users
- Using appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement
- Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
  - Generate copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
  - Integrate the copies into the engagement files, including indexing and signing off on the copies as necessary.
  - Enable the copies to be retrieved and printed as necessary.

4.29 *Policy 5: I retain engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Retaining engagement documentation for a period of time sufficient to meet the requirements of the state board of accountancy and applicable professional standards
- Enabling the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time
- Providing, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed
- Enabling authorized external parties to access and review specific engagement documentation for quality control or other purposes

4.30 *Policy 6: I require that consultation take place when appropriate; I make sufficient and appropriate resources available to enable appropriate consultation to take place; I provide to those consulted all the relevant facts known to me; I document the nature, scope, and conclusions of such consultations; and I implement conclusions resulting from such consultations.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Maintaining current technical references to assist in resolving practice problems
- Referring to the AICPA's Technical Hotline or other qualified individuals if a practice problem arises for which the firm needs additional expertise
- Requiring that documentation of consultation include the following:
    - — All relevant facts and circumstances about the issue on which consultation was sought.
    - — References to professional literature used in the analysis of the matter.
    - — The results of the consultation, including any decisions made, the basis for those decisions, and how they were implemented. This documentation is retained with the engagement documentation.

4.31 *Policy 7: I deal with and resolve differences of opinion; I document and implement the conclusions reached; and I do not release the report until the matter is resolved.* Sole Practitioner, CPA, implements this policy by (*a*) evaluating issues of professional judgment when differences of opinion arise with per-diem personnel, with those consulted, or with an external reviewer and (*b*) resolving the matter before releasing the report. If persons involved in the engagement continue to disagree with the resolution, they may disassociate themselves from the resolution of the matter and document that a disagreement continues to exist.

4.32 *Policy 8: I have criteria for determining whether an engagement quality control review should be performed; I evaluate all engagements against the criteria before I accept the engagement; I contract with a qualified external person to perform the engagement quality control review; and I do not release the report until the review is completed.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Establishing the following criteria for determining whether an engagement quality control review should be performed:
    - — The engagement is subject to Statements on Auditing Standards (SASs) or Statements on Standards for Attestation Engagements (SSAEs).
    - — An initial engagement for a client is in a specialized industry in which Sole Practitioner, CPA, has had no previous experience.
    - — An engagement quality control review is required by law or regulation.
- Evaluating all engagements against the criteria
- Contracting with a qualified external person to perform the engagement quality control review
- Not releasing the report until the review is completed

Monitoring

4.33 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 related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

4.34 Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 4.35–.39.

4.35 *Policy 1: I perform monitoring procedures that are sufficiently comprehensive to enable me to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Performing a postissuance review of selected engagements at least annually[2]
- Summarizing the findings from the firm's monitoring procedures at least annually and considering the systemic causes of findings that indicate improvements are needed
- Determining any corrective actions or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures and taking those actions, including necessary modifications to the quality control system, on a timely basis
- Reviewing compliance with the firm's policies and procedures related to relevant ethical responsibilities, including independence, human resources, acceptance and continuance of client relationships and specific engagements, and engagement performance
- Reviewing all policies and procedures and revising those affected by changes in professional standards or the nature of her practice
- Reviewing and determining that the firm's practice aids are current and reflect recent professional pronouncements and changes in her practice
- Reviewing CPE records to determine whether the classroom training and self-study programs she uses are appropriate for the firm's practice
- Reviewing CPE records to determine compliance with the requirements of the AICPA and other applicable regulatory agencies

4.36 *Policy 2: I deal appropriately with complaints and allegations.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Investigating the following:
    - — Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
    - — Allegations of noncompliance with the firm's system of quality control
    - — Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations
- Documenting complaints and allegations and the responses to them

4.37 *Policy 3: I prepare appropriate documentation to provide evidence of the operation of each element of the firm's system of quality control.* Sole Practitioner, CPA, implements this policy by documenting evidence of the operation of each element of the firm's system of quality control by preparing a memorandum of the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be subject to postissuance review
- A record of the evaluation of the following:
    - — Adherence to professional standards and regulatory and legal requirements
    - — Whether the quality control system has been appropriately designed and effectively implemented

[2] A postissuance review may be performed as part of an inspection. A sole proprietor may consider engaging another CPA to perform the inspection to obtain a fresh look at the engagement. See paragraph 3.52, "Scenario 2: Monitoring by Inspecting a Sample of Engagements During a Designated Period of the Year," for a description of how a firm considers and evaluates, on an ongoing basis, compliance with a firm's policies and procedures by performing an annual inspection. Note that a preissuance review by the sole proprietor does not satisfy the monitoring requirements.

- — Whether the firm's quality control policies and procedures have been appropriately applied so that reports that are issued by the firm are appropriate in the circumstances
- Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be

4.38 Although the form and content of that documentation is a matter of judgment, the illustration in table 1 in this chapter is an example of such documentation.

4.39 *Policy 4: I retain documentation of evidence of the operation of the system of quality control for an appropriate period of time.* Sole Practitioner, CPA, implements this policy by requiring retention of the summary report for a period of time sufficient to meet the firm's peer review or other regulatory requirements.

Table 1: Summary of Quality Control Monitoring For the Calendar Year 20XX

Element of Quality Control and Applicable Policies	*Reviewer's Initials and Date Reviewed*	*Location of Additional Documentation*
Leadership Responsibilities for Quality Within the Firm		**These policies are evidenced by the overall operation of the firm's system of quality control.**
Relevant Ethical Requirements		
Policy 1. Adhering to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, and other applicable regulators	JB 6/30/XX	Independence confirmation files
Policy 2. Communicating independence requirements to per-diem professionals and, where applicable, others subject to them	JB 6/30/XX	Independence confirmation files
Policy 3. Establishing procedures to help mitigate possible threats to my independence and objectivity	JB 6/30/XX	Independence confirmation files
Policy 4. Confirming, in writing, my compliance with policies and procedures on independence and obtaining written confirmation from all per-diem professionals required to be independent by relevant requirements	JB 6/30/XX	Independence confirmation files
Acceptance and Continuance of Client Relationships and Specific Engagements		
Policy 1. Evaluating factors that have a bearing on management's integrity and considering the risk associated with providing professional services in particular circumstances	JB 6/30/XX	Client acceptance files and client engagement files

Element of Quality Control and Applicable Policies	*Reviewer's Initials and Date Reviewed*	*Location of Additional Documentation*
Policy 2. Accepting or continuing to perform only those engagements that I can complete with professional competence and evaluating whether the relationship should be continued	JB 6/30/XX	Engagement files
Policy 3. Obtaining an understanding with the client regarding services to be performed	JB 6/30/XX	Engagement files
Policy 4. Following established procedures on withdrawal from an engagement or from both the engagement and the client relationship	JB 6/30/XX	Not applicable for year ended 20XX
Policy 5. Documenting how issues relating to acceptance or continuance of client relationships and specific engagements were resolved	JB 6/30/XX	Client acceptance files and client engagement files
Human Resources		
Policy 1. Hiring per-diem personnel of integrity who possess the characteristics that enable them to perform competently	JB 6/30/XX	Personnel files
Policy 2. (*a*) Maintaining the knowledge, skills, and abilities required in the circumstances by participating in general and industry-specific continuing professional education (CPE) and professional development activities that enable me to accomplish my responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA society, state boards of accountancy, and other applicable regulators and (*b*) monitoring for compliance the CPE requirements of per-diem employees	JB 6/30/XX	Personnel files
Engagement Performance		
Policy 1. Planning engagements to meet professional standards, regulatory requirements, and the firm's requirements	JB 6/30/XX	Engagement files
Policy 2. Performing, supervising, reviewing, documenting, and reporting (or communicating) in accordance with the requirements of professional standards	JB 6/30/XX	Engagement files
Policy 3. Completing the assembly of final engagement files on a timely basis	JB 6/30/XX	Engagement files
Policy 4. Maintaining the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation	JB 6/30/XX	Engagement files

(continued)

Element of Quality Control and Applicable Policies	*Reviewer's Initials and Date Reviewed*	*Location of Additional Documentation*
Policy 5. Retaining engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations	JB 6/30/XX	Engagement files
Policy 6. Requiring that consultation take place when appropriate; making sufficient and appropriate resources available to enable appropriate consultation to take place; providing to those consulted all the relevant facts known to me; documenting the nature, scope, and conclusions of such consultations; and implementing conclusions resulting from such consultations	JB 6/30/XX	Engagement files
Policy 7. Dealing with and resolving differences of opinion; documenting and implementing the conclusions reached; and not releasing the report until the matter is resolved	JB 6/30/XX	Engagement files
Policy 8. Evaluating all engagements against my criteria for an engagement quality control review; contracting with a qualified external person to perform the engagement quality control review; and not releasing the report until the review is completed	JB 6/30/XX	Client acceptance files
Monitoring		
Policy 1. Performing monitoring procedures that are sufficiently comprehensive to enable me to assess compliance with all applicable professional standards and the firm's quality control policies and procedures	JB 6/30/XX	Monitoring files
Policy 2. Dealing appropriately with complaints and allegations	JB 6/30/XX	Engagement files
Policy 3. Preparing appropriate documentation to provide evidence of the operation of each element of the firm's system of quality control	JB 6/30/XX	Monitoring files
Policy 4. Retaining documentation of evidence of the operation of the system of quality control for an appropriate period of time	JB 6/30/XX	Monitoring files

Chapter 5:

System of Quality Control for an Alternative Practice Structure

5.01 An alternative practice structure, as referred to in this practice aid, is a nontraditional structure in the practice of public accounting that contains an attest and a nonattest portion. The attest portion is conducted through a firm owned and controlled by CPAs (a *closely aligned CPA firm*). The nonattest portion is conducted through a separate issuer or nonissuer firm owned and controlled by individuals who are not CPAs (a *non-CPA-owned entity*[1]). The non-CPA-owned entity may be an issuer or a nonissurer. Alternative practice structures are described in Interpretation 101-14, "The Effect of Alternative Practice Structures on the Applicability of Independence Rules," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .16), which is included as appendix B of this practice aid.

5.02 The quality control policies and procedures established by a closely aligned CPA firm that may or may not perform audit services are illustrated in chapters 2–3, as applicable. Additional quality control policies and procedures relevant to alternative practice structures may be necessary when certain portions of the CPA firm's system of quality control (*a*) reside at the non-CPA-owned entity or (*b*) operate in conjunction with the system of quality control of the non-CPA-owned entity.

5.03 Elements of quality control that might reside in a non-CPA-owned entity include the following:

- Relevant ethical requirements
- Human resources
- Monitoring of relevant ethical requirements and human resources

For example, the non-CPA-owned entity may be responsible for hiring personnel for both firms.

5.04 This chapter describes how Non-CPA-Owned Entity and Closely Aligned CPA Firm, hypothetical firms that are organized in an alternative practice structure, implement incremental quality control policies and procedures to address the previously mentioned elements of quality control that reside at Non-CPA-Owned Entity. Closely Aligned CPA Firm has no issuer clients[2] and implements the policies and procedures described in chapter 2 of this practice aid.

Quality Control Policies and Procedures

5.05 *Policy 1: The top-tier company*[3] *maintains a system of quality control.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Designating a qualified individual to be responsible for the following:
  - — Designing and directing the quality control activities at the top-tier company
  - — Disseminating information to all subsidiaries and affiliated entities, all subsidiaries associated with CPA firms, and all CPA firms closely aligned with company subsidiaries
- Providing all company personnel and indirect superiors[4] with access to the company's quality control policies and procedures

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[1] A *non-CPA-owned entity* is an entity that is closely aligned to a CPA firm through common employment; leasing of employees, equipment, or facilities; or other similar arrangements. In addition to one or more professional service subsidiaries or divisions that offer nonattest professional services (for example, tax, personal financial planning, and management consulting), a non-CPA-owned entity may have subsidiaries or divisions such as a bank, insurance company, or broker-dealer.

[2] If the closely aligned CPA firm were to be engaged to perform audit services for an issuer, the non-CPA-owned entity or its affiliated companies might need to revise their quality control policies and procedures to comply with Public Company Accounting Oversight Board (PCAOB) standards and to reflect Securities and Exchange Commission (SEC) requirements applicable to audits of issuers.

[3] The top-tier company is the parent company of the non-CPA-owned entity, which may be an issuer.

[4] Indirect superiors may be involved in regional management of direct superiors; thus, they may need to adhere to requirements.

Relevant Ethical Requirements

5.06 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Closely Aligned CPA Firm satisfies this objective by ensuring that Non-CPA-Owned Entity establishes and maintains the policies and procedures described in paragraphs 5.07–.09.

5.07 *Policy 1: Non-CPA-Owned Entity adheres to applicable relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes,the GAO, and any other applicable regulators.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Developing policies and procedures to ensure the independence of Closely Aligned CPA Firm as required by the applicable aforementioned regulators. (Non-CPA-Owned Entity is required to be independent only in the context of its alignment with the CPA firm; it does not perform any attest functions, so its independence is not relevant.)
- Designating an officer to be responsible for providing guidance, answering questions, monitoring compliance, and resolving matters concerning independence, integrity, and objectivity of Closely Aligned CPA Firm.
- Determining when consultation with outside sources regarding independence, integrity, and objectivity matters is required.
- Reviewing written representations from *direct superiors* and *indirect superiors*[5] and others as applicable and resolving potential independence, integrity, and objectivity matters.
- Maintaining documentation of the resolution of independence, integrity, and objectivity matters.
- Requiring entity personnel to obtain sufficient training and education to accomplish their responsibilities with respect to independence, integrity, and objectivity.
- Obtaining from Closely Aligned CPA Firm a current list of all entities with which firm personnel are prohibited from having a financial or business relationship.[6]
- Obtaining written representations from personnel of Non-CPA-Owned Entity, upon hire and on an annual basis, stating that they are familiar with and in compliance with Non-CPA-Owned Entity's policies and procedures regarding independence, integrity, and objectivity.

5.08 *Policy 2: Personnel of Non-CPA-Owned Entity are familiar with policies and procedures regarding relevant ethical requirements.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Providing all of its personnel with access to its policies and procedures and guidance materials related to independence, integrity, and objectivity, such as manuals, memoranda, and databases containing professional and regulatory literature
- Advising personnel of Non-CPA-Owned Entity of the financial or other relationships, circumstances, or activities involving either individuals or entities that may be prohibited, as in the following examples:

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[5] *Direct superiors* are defined to include those persons so closely associated with a partner or manager who is a covered member that such persons can directly control the activities of such partner or manager. For this purpose, a person who can directly control is the immediate superior of the partner or manager who has the power to direct the activities of that person so as to be able to directly or indirectly (for example, through another entity over which the direct superior can exercise significant influence) derive a benefit from that person's activities. Examples would be the person who has day-to-day responsibility for the activities of the partner or manager and is in a position to recommend promotions and compensation levels. *Indirect superiors* are those persons who are one or more levels above direct superiors. Generally, this would start with persons in an organization structure to whom direct superiors report and go up the line from there.

[6] Examples of business relationships prohibited by independence standard-setting bodies such as the AICPA, the GAO, and the U.S. Department of Labor because they might impair independence include being an investor in a joint venture with a client that is material or serving as a board member on the board of an audit client.

- — Business relationships with Closely Aligned CPA Firm's clients or with nonclients that have investor or investee relationships with Closely Aligned CPA Firm's clients
- — Loans to and from Closely Aligned CPA Firm's clients, including loans from Closely Aligned CPA Firm's financial institution clients
- — Family members who are employed by Closely Aligned CPA Firm's clients or who serve as director, officer, manager, or in other audit-sensitive positions with clients of Closely Aligned CPA Firm, including not-for-profit organizations
- — Past due fees from Closely Aligned CPA Firm's clients
- — Services in which the service provider assumes some of the responsibilities of client management
- — Performing certain bookkeeping services for governmental entities that are clients of Closely Aligned CPA Firm
- — Client relationships with Non-CPA-Owned Entity in which Closely Aligned CPA Firm leases employees, facilities, and so on
- — Situations in which personnel of Non-CPA-Owned Entity act as promoters, underwriters, voting trustees, directors, or officers of Closely Aligned CPA Firm's clients
- — Direct and material indirect financial interests in clients of Closely Aligned CPA Firm
- — Material investments by Closely Aligned CPA Firm's clients in Non-CPA-Owned Entity that allow the clients to exercise significant influence over Non-CPA-Owned Entity

- Advising personnel of Non-CPA-Owned Entity of the following:
  - — All direct superiors with whom, and all activities in which, Non-CPA-Owned Entity is prohibited from engaging, as defined in Non-CPA-Owned Entity's independence policies and procedures
  - — All indirect superiors with whom, and all activities in which, Non-CPA-Owned Entity is prohibited from engaging, as defined by Non-CPA-Owned Entity's policies and procedures
- Obtaining client lists from Closely Aligned CPA Firm to inform all personnel, on a timely basis, of Closely Aligned CPA Firm client's to which independence policies apply
- Obtaining documented representations from all Non-CPA-Owned Entity personnel (including those defined as direct and indirect superiors or supervisors of affiliated issuers),[7] upon hire and on an annual basis thereafter, stating that they are familiar with and in compliance with policies and procedures regarding relevant ethical requirements

5.09 *Policy 3: Non-CPA-Owned Entity identifies and evaluates possible threats to independence and objectivity and takes appropriate action to eliminate those threats or reduce them to an appropriate level by applying safeguards.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Assigning responsibility for obtaining, maintaining, and reviewing documented representations from all Non-CPA-Owned Entity personnel (see paragraph 5.08) for completeness and resolving reported exceptions with Non-CPA-Owned Entity's chief executive
- Requiring the chief executive of Non-CPA-Owned Entity to review or to designate an appropriate individual to review unpaid fees from clients of Closely Aligned CPA Firm to ascertain whether any outstanding amounts impair Closely Aligned CPA Firm's independence
- Requiring all professionals to report, on a timely basis when identified, circumstances and relationships that form a threat to independence so that appropriate action can be taken

[7] Affiliated issuers include the top-tier company and all entities consolidated in the top-tier company's financial statements. Individuals in these entities are not in situations in which a direct superior can exercise significant influence.

- Requiring all professionals to report, on a timely basis when identified, apparent violations of independence, integrity, or objectivity policies involving themselves, their spouses, or their dependents and the corrective actions taken or proposed to be taken

Human Resources

5.10 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Closely Aligned CPA Firm satisfies this objective by ensuring that Non-CPA-Owned Entity establishes and maintains the policies and procedures comparable to those that are described in paragraphs 5.11–.13 with regard to its leased or per-diem personnel.

5.11 *Policy 1: Leased or per-diem personnel possess characteristics that enable them to competently perform and review engagements.* Non-CPA-Owned Entity implements this policy by having knowledge and experience equivalent to that of Closely Aligned CPA Firm to make the following decisions:

- Designating an individual from Closely Aligned CPA Firm to be responsible for hiring and managing human resources within Non-CPA-Owned Entity on behalf of Closely Aligned CPA Firm.
- Reviewing Closely Aligned CPA Firm's personnel requirements for attest engagements to ensure that sufficient and capable staff persons are available to perform those engagements.
- Involving members of Closely Aligned CPA Firm in the process of hiring professionals on behalf of Closely Aligned CPA Firm that include establishing the attributes, achievements, and experiences desired in entry-level and experienced personnel. Such criteria assist in evaluating (*a*) the personal characteristics of professionals, such as integrity, competence, and motivation, and (*b*) whether professionals can competently perform responsibilities within Closely Aligned CPA Firm.
- Establishing guidelines for additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions.
- Establishing criteria for determining which individuals will be involved in interviewing and hiring personnel on behalf of Closely Aligned CPA Firm.

5.12 *Policy 2: Leased or per-diem personnel participate in general and industry-specific continuing professional education (CPE) and other professional activities that enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state accountancy boards, and other regulatory agencies.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Designating an individual to be responsible for CPE and professional development activities, including maintaining appropriate documentation evidencing that leased and per-diem personnel have met the professional education requirements of the AICPA, state boards of accountancy, and other applicable regulators
- Establishing policies that require individuals performing audits, reviews, compilations, or attestation engagements for Closely Aligned CPA Firm to participate in CPE related to accounting and auditing
- Establishing policies requiring all leased or per-diem personnel to be in compliance with the professional education requirements of the boards of accountancy in states where they are licensed and with the AICPA, state societies, and other regulatory agencies, as applicable
- Establishing an orientation and training policy for new hires who will perform audits, reviews, compilations, or attestation engagements for Closely Aligned CPA Firm or who will have partner- or manager-level responsibility for the overall supervision or review of such engagements

- Ensuring that leased or per-diem personnel are informed about changes in accounting and auditing standards, independence, integrity, and objectivity requirements, and Closely Aligned CPA Firm's technical policies and procedures that are relevant to them
- Encouraging leased or per-diem personnel to participate in other professional activities, such as graduate-level courses, membership in professional organizations, and serving on professional committees

5.13 *Policy 3: Leased or per-diem personnel who are selected for advancement have the qualifications to accomplish the responsibilities they will be called upon to assume. Factors to consider include the degree of technical training and proficiency required in the circumstances and the nature and extent of supervision of assignments relating to audits, reviews, compilations, or attestation engagements performed by Closely Aligned CPA Firm.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Establishing a system for providing information to Closely Aligned CPA Firm so that it can make appropriate personnel decisions, such as assignments for audits, reviews, compilations, and attestation engagements.
- Designating an individual to be responsible for the following:
  - Establishing criteria for the evaluation and advancement of leased or per-diem personnel, including appropriate documentation
  - Making advancement and termination decisions, including identifying responsibilities and requirements for evaluation, at each professional level and deciding who will prepare those evaluations
  - Developing appropriate evaluation forms
  - Reviewing performance evaluations with personnel, discussing future objectives of Closely Aligned CPA Firm and the individual, and discussing assignment preferences
  - Periodically evaluating owners of Closely Aligned CPA Firm by means of peer evaluation or self-appraisal
  - Counseling leased or per-diem personnel regarding their progress and career opportunities
- Establishing an arrangement with Closely Aligned CPA Firm in which a supervisory-level individual of Closely Aligned CPA Firm is responsible for assisting Non-CPA-Owned Entity in making advancement and termination decisions concerning leased or per-diem personnel. This would include evaluating personnel needs, establishing hiring objectives, and providing final approval.
- Developing a system for evaluating the performance of leased or per-diem personnel and advising them of their progress.

Monitoring

5.14 The objective of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the CPA firm are appropriate in the circumstances

5.15 A CPA firm that is closely aligned with a non-CPA-owned entity satisfies this objective by ensuring that the non-CPA-owned entity establishes and maintains the policies and procedures described in paragraphs 5.16–.19.

5.16 *Policy 1: Non-CPA-Owned Entity considers and evaluates, on an ongoing basis, the relevance and adequacy of its policies and procedures related to relevant ethical requirements that are applicable to all its personnel and its personnel management policies and procedures that are applicable to leased or per-diem personnel.* Non-CPA-Owned Entity implements this policy by designating qualified individuals to be responsible for monitoring quality assurance, including ensuring that Non-CPA-Owned Entity's quality control guidance is regularly updated to reflect changes in professional standards related to independence, CPE, and other regulatory requirements through the following procedures:

- Implementing a system of ongoing monitoring of the effectiveness and appropriateness of policies and procedures related to independence, objectivity, and integrity as applicable to all personnel of Non-CPA-Owned Entity and compliance with those policies and procedures
- Ensuring, on an ongoing basis, that guidance materials and any practice aids Non-CPA-Owned Entity provides to Closely Aligned CPA Firm are appropriately designed to assist Closely Aligned CPA Firm in adhering to quality control standards
- Maintaining a system to ensure that the practice aids regarding independence and other technical matters provided by Non-CPA-Owned Entity are updated to reflect current professional standards and regulatory requirements and are relevant to and effective for Closely Aligned CPA Firm's practice
- Ensuring that Non-CPA-Owned Entity informs and provides guidance to leased or per-diem personnel regarding new professional standards, regulatory requirements, and related changes to relevant Closely Aligned CPA Firm policies or practice aids

5.17 *Policy 2: Non-CPA-Owned Entity considers and evaluates, on an ongoing basis, compliance with its policies and procedures related to relevant ethical requirements that are applicable to all of its personnel and personnel management policies and procedures that are applicable to leased or per-diem personnel.* Non-CPA-Owned Entity implements this policy by considering and evaluating, on an ongoing basis, compliance with policies and procedures related to independence, integrity, and objectivity, as applicable to all of its personnel, through the following procedures:

- Performing timely monitoring of policies and procedures, on an ongoing basis, related to independence, integrity, and objectivity to evaluate compliance with those policies and procedures. The monitoring policies and procedures could include an internal audit function, ongoing review by senior management, or engaging an independent CPA to examine and report on compliance.
- Summarizing and communicating the results of the monitoring to all of its personnel and communicating any suggested changes to policies and procedures to the appropriate levels of personnel in Non-CPA-Owned Entity.
- Correcting noted deficiencies based on the results of the monitoring to ensure compliance with policies and procedures.

5.18 *Policy 3: Non-CPA-Owned Entity deals appropriately with complaints and allegations.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Performing timely monitoring of policies and procedures, on an ongoing basis, related to independence, integrity, and objectivity to evaluate compliance with those policies and procedures. The monitoring policies and procedures could include an internal audit function, ongoing review by senior management, or engaging an independent CPA to examine and report on compliance.
- Having the firm's ethics committee (excluding any members who are otherwise involved in the engagement under investigation) investigate the following:

- — Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
- — Allegations of noncompliance with the firm's system of quality control
- — Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations

- Documenting complaints and allegations and the responses to them.

5.19 *Policy 4: Non-CPA-Owned Entity prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control.* Non-CPA-Owned Entity implements this policy by preparing and retaining documentation that provides evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control.

Appendix A:

Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control*

Supersedes SQCSs Nos. 2–6. SQCS No. 1 was previously superseded by SQCS No. 2.

Source: SQCS No. 7.

Effective date: Applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2009.

Statements on Quality Control Standards (SQCS) are issued by the Auditing Standards Board. Firms that are enrolled in an Institute-approved practice-monitoring program are obligated to adhere to quality control standards established by the Institute.

On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002 (Act) which created a five-member Public Company Accounting Oversight Board (PCAOB) and charged it with overseeing audits of issuers, as defined by the Act, or other entities subject to SEC regulation (issuers). Under the Act, the PCAOB's duties include, among other things, establishing auditing, quality control, ethics, independence, and other Standards relating to audits of issuers.

The AICPA's Quality Control Standards do not address the quality-control ramifications of the Act nor do they address the quality control ramifications of PCAOB Standards that must be followed by auditors of issuers. The AICPA's Quality Control Standards do not purport to include any modifications that may be necessary for a firm's system of quality control to conform to PCAOB Standards. Additional information about the PCAOB and the Act can be obtained at the PCAOB Web site, www.pcaobus.org, and the AICPA Web site, http://thecaq.aicpa.org/Resources/Sarbanes+Oxley/.

Introduction

.01 The purpose of this section is to establish standards and provide guidance for a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. This section describes elements of quality control and other matters essential to the effective design, implementation, and maintenance of the system. This section is to be read in conjunction with the AICPA Code of Professional Conduct.

.02 This section also sets forth the meaning of certain terms used in SQCSs issued by the Auditing Standards Board in describing the professional requirements imposed on firms and engagement partners.

System of Quality Control

.03 The firm must establish a system of quality control designed to provide the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the circumstances. A system of quality control consists of policies designed to achieve these objectives and the procedures necessary to implement and monitor compliance with those policies.

.04 The nature of the policies and procedures developed by individual firms to comply with this section will depend on various factors such as the size and operating characteristics of the firm. The system of quality control should be designed to provide the firm with reasonable assurance that the segments of the firm's engagements performed by its foreign member firms or offices or by its domestic or foreign affiliates, if any, are performed in accordance with professional standards in the United States when such standards are applicable.

Definitions

.05 In this section, the following terms have the meanings given:

a. *Accounting and auditing practice.* A practice that performs engagements covered by this section, which are audit, attestation, compilation, review and any other services for which standards have been 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 (ET sections 201–202). Although standards for other engagements may be established by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an accounting and auditing practice.

b. *Engagement documentation.* The record of work performed, results obtained, and conclusions the practitioner reached, also known as *working papers* or *workpapers*.

c. *Engagement partner.* An individual responsible for supervising engagements covered by this section and signing or authorizing an individual to sign the report on such engagements, and who, where required, has the appropriate authority from a professional, legal or regulatory body. Firms may use different titles to refer to individuals with this authority.

d. *Engagement quality control review.* A process designed to provide an objective evaluation, by an individual or individuals who are not members of the engagement team, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

e. *Engagement quality control reviewer.* A partner, other person in the firm, qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to perform the engagement quality control review.

f. *Engagement team.* All personnel performing the engagement, excluding those who perform the engagement quality control review. The engagement team (i) includes all employees and contractors retained by the firm who perform engagement procedures, irrespective of their functional classification (for example, audit, tax, or management consulting services) and (ii) excludes specialists as discussed in AU section 336, *Using the Work of a Specialist*, and individuals who perform only routine clerical functions, such as word processing and photocopying.

g. *Firm.* A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the American Institute of Certified Public Accountants that is engaged in the practice of public accounting.

h. *Inspection*. A retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures and the extent of the firm's compliance with them. Inspection is an element of monitoring.

i. *Monitoring*. A process comprising an ongoing consideration and evaluation of the firm's system of quality control, the objective of which is to enable the firm to obtain reasonable assurance that its system of quality control is designed appropriately and operating effectively.

j. *Partner.* An individual with authority to bind the firm with respect to the performance of a professional services engagement. For purposes of this definition, partner may include an employee with this authority who has not assumed the risks and benefits of ownership. Firms may use different titles to refer to individuals with this authority.

k. *Personnel*. All individuals who perform professional services for which the firm is responsible, whether or not they are CPAs.

l. *Professional standards*. Standards 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 or other standard setting bodies that set auditing and attest standards applicable to the engagement being performed.

m. *Qualified external person.* An individual outside the firm with the capabilities and competence to act as an engagement partner.

n. *Reasonable assurance.* In the context of this standard, a high, but not absolute, level of assurance.

o. *Relevant ethical requirements*. Ethical requirements to which the firm and its personnel are subject, which consist of the AICPA Code of Professional Conduct together with rules of state boards of accountancy and applicable regulatory agencies, which may be more restrictive.

p. *Staff*. Personnel, other than partners and engagement partners, including any specialists who are employees of the firm.

Professional Requirements

.06 SQCSs contain professional requirements together with related guidance in the form of explanatory material. Firms have a responsibility to consider the entire text of an SQCS with regard to their system of quality control and in understanding and applying the professional requirements of the relevant SQCSs.

.07 Not every paragraph of an SQCS carries a professional requirement that the firm is expected to fulfill. Rather, the professional requirements are communicated by the language and the meaning of the words used in the SQCSs.

.08 SQCSs use two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on firms, as follows:

- *Unconditional requirements.* The firm is required to comply with an unconditional requirement in all cases in which the circumstances exist to which the unconditional requirement applies. SQCSs use the words *must* or *is required* to indicate an unconditional requirement.
- *Presumptively mandatory requirements.* The firm is also required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, the firm may depart from a presumptively mandatory requirement provided the practitioner documents his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. SQCSs use the word *should* to indicate a presumptively mandatory requirement.

If an SQCS provides that a procedure or action is one that the firm "should consider," the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not. The professional requirements of an SQCS are to be understood and applied in the context of the explanatory material that provides guidance for their application.

Explanatory Material

.09 Explanatory material is defined as the text within an SQCS (excluding any related interpretations[1]) that may:

- Provide further explanation and guidance on the professional requirements; or
- Identify and describe other procedures or actions relating to the activities of the firm.

[1] Interpretive publications differ from explanatory material. Interpretive publications, for example, interpretations of the SQCSs, reside outside of the standards section of an SQCS and are recommendations on the application of the SQCS in specific circumstances. In contrast, explanatory material is always contained within the standards sections of the SQCS and is meant to be more descriptive in nature.

.10 Explanatory material that provides further explanation and guidance on the professional requirements is intended to be descriptive rather than imperative. That is, it explains the objective of the professional requirements (where not otherwise self-evident); it explains why the firm might consider or employ particular procedures, depending on the circumstances; and it provides additional information for the firm to consider in exercising professional judgment with regard to its system of quality control.

.11 Explanatory material that identifies and describes other procedures or actions relating to the activities of the firm is not intended to impose a professional requirement for the firm to perform the suggested procedures or actions. Rather, these procedures or actions require the firm's attention and understanding; how and whether the firm carries out such procedures or actions with regard to its system of quality control depends on the exercise of professional judgment in the circumstances consistent with the objective of the standard. The words *may*, *might*, and *could* are used to describe these actions and procedures.

Documentation and Communication of Quality Control Policies and Procedures

.12 The firm should document its quality control policies and procedures. The size, structure, and nature of the practice of the firm are important considerations in determining the extent of the documentation of established quality control policies and procedures. For example, documentation of established quality control policies and procedures would generally be expected to be more extensive in a large firm than in a small firm and in a multioffice firm than in a single-office firm.

.13 The firm should communicate its quality control policies and procedures to its personnel. Although communication is enhanced if it is in writing, the communication of quality control policies and procedures is not required to be in writing. Effective communication of the firm's quality control policies and procedures:

- Describes the quality control policies and procedures and the objectives they are designed to achieve;
- Includes the message that each individual has a personal responsibility for quality and is expected to be familiar with and to comply with these policies and procedures; and
- Stresses the importance of obtaining feedback on its system of quality control from its personnel and encourages its personnel to communicate their views or concerns on quality control matters.

Elements of a System of Quality Control

.14 The firm's system of quality control should include policies and procedures addressing each of the following elements:

a. Leadership responsibilities for quality within the firm (the "tone at the top")

b. Relevant ethical requirements

c. Acceptance and continuance of client relationships and specific engagements

d. Human resources

e. Engagement performance

f. Monitoring

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

.15 The firm should promote an internal culture based on the recognition that quality is essential in performing engagements and should establish policies and procedures to support that culture. Such policies and procedures should require the firm's leadership (managing partner or board of managing partners, chief executive officer, or equivalent) to assume ultimate responsibility for the firm's system of quality control.

.16 The firm's leadership and the examples it sets significantly influence the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent, and frequent actions and messages from all levels of the firm's management that emphasize the firm's quality control policies and procedures, and the requirement to:

a. Perform work that complies with professional standards and regulatory and legal requirements.

b. Issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognizes and rewards quality work. These actions and messages may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They may be incorporated in the firm's internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.

.17 Of particular importance in promoting an internal culture based on quality is the need for the firm's leadership to recognize that the firm's business strategy is subject to the overarching requirement for the firm to achieve the objectives of the system of quality control in all the engagements that the firm performs. Accordingly, the firm should establish policies to:

a. Assign management responsibilities so that commercial considerations do not override the quality of work performed;

b. Address performance evaluation, compensation, and advancement (including incentive systems) with regard to its personnel, to demonstrate the firm's overarching commitment to the objectives of the system of quality control; and

c. Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

.18 Any person or persons assigned operational responsibility for the firm's quality control system by the firm's leadership should have sufficient and appropriate experience and ability to identify and understand quality control issues and to develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.

Relevant Ethical Requirements

.19 The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

.20 The AICPA Code of Professional Conduct establishes the fundamental principles of professional ethics, which include:

- Responsibilities
- The public interest
- Integrity
- Objectivity and independence
- Due care
- Scope and nature of services

.21 The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel, and, where applicable, others subject to independence requirements, maintain independence where required. Independence requirements are set forth in Rule 101 (ET section 101) and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Guidance on threats to independence, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and safeguards to mitigate such threats involving matters that are not explicitly addressed in the Code of Professional Conduct, are set forth in the AICPA's Conceptual Framework for AICPA Independence Standards. Such policies and procedures should enable the firm to:

a. Communicate its independence requirements to its personnel and, where applicable, others subject to them.

b. Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if effective safeguards cannot be applied, withdrawing from the engagement.[2]

.22 Such policies and procedures should require:

a. The engagement partner to consider relevant information about client engagements, including the scope of services, to enable him or her to evaluate the overall effect, if any, on independence requirements.

b. Personnel to promptly notify the engagement partner and the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken.

c. The accumulation and communication of relevant information to appropriate personnel so that:

(i) The firm, the engagement partner, and other firm personnel can readily determine whether they satisfy independence requirements;

(ii) The firm can maintain and update information relating to independence; and

(iii) The firm and the engagement partner can take appropriate action regarding identified threats to independence.

.23 The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for:

a. Personnel to promptly notify the firm of independence breaches of which they become aware.

b. The firm to promptly communicate identified breaches of these policies and procedures and the required corrective actions to:

(i) The engagement partner who, with the firm, has the responsibility to address the breach; and

(ii) Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action.

c. Confirmation to the firm by the engagement partner and the other individuals referred to in subparagraph b.(ii) that the required corrective actions have been taken.

.24 At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the requirements set forth in Rule 101 and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Written confirmation may be in paper or electronic form.

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[2] An accountant is not precluded from issuing a report with respect to a compilation of financial statements for an entity with respect to which the accountant is not independent. If the accountant is not independent, disclosure of the accountant's lack of independence is the appropriate response.

.25 The purpose of obtaining confirmation and taking appropriate action on information indicating noncompliance is to demonstrate the importance that the firm attaches to independence and keep the issue current for and visible to its personnel.

.26 For all audit or attestation engagements where regulatory or other authorities require the rotation of personnel after a specified period, the firm's policies and procedures should address these requirements.

Acceptance and Continuance of Client Relationships and Specific Engagements

.27 The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where the firm:

a. Has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;

b. Is competent to perform the engagement and has the capabilities and resources to do so; and

c. Can comply with legal and ethical requirements.

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

.28 To minimize the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed, policies and procedures should provide for obtaining an understanding with the client regarding those services. Professional standards may provide guidance in deciding whether the understanding should be oral or written.

.29 When issues have been identified, and the firm has decided to accept or continue the client relationship or a specific engagement, the firm should document how the issues were resolved.

.30 Factors to consider regarding the integrity of a client include:

- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

.31 Matters to consider in accepting or continuing the client engagement include whether:

- Firm personnel have knowledge of relevant industries or subject matters or the ability to effectively gain the necessary knowledge;
- Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to effectively gain the necessary competencies;
- The firm has sufficient personnel with the necessary capabilities and competence;
- Specialists are available, if needed;
- Individuals meeting the criteria and eligibility requirements to perform an engagement quality control review are available, where applicable; and
- The firm is able to complete the engagement within the reporting deadline.

.32 If a potential conflict of interest is identified in accepting an engagement from a new or an existing client, the firm should determine whether it is appropriate to accept the engagement. Where the engagement is accepted, the firm should consider any ethical requirements that exist under AICPA Interpretation No. 102-2, "Conflicts of Interest," under Rule 102, *Integrity and Objectivity* (ET section 102), such as disclosure of the relationship to the client and other appropriate parties.

.33 Deciding whether to continue a client relationship includes consideration of significant issues that have arisen during the current or previous engagements, and their implications for continuing the relationship.

.34 If the firm obtains information that would have caused it to decline an engagement if that information had been available earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of the professional and legal responsibilities that apply to the circumstances, and the possibility of withdrawing from the engagement or from both the engagement and the client relationship.

.35 Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship should include documenting significant issues, consultations, conclusions, and the basis for the conclusions. Policies and procedures may include:

- Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances.
- Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship.

.36 In certain situations, the auditor may be appointed by statutory procedures or required by law or regulation to perform the engagement. Accordingly, certain of the considerations regarding the acceptance and continuance of client relationships and specific engagements, as set out in paragraphs .27–.35, may not be relevant. Nonetheless, establishing policies and procedures as described may provide valuable information to public sector auditors in performing risk assessments and in carrying out reporting responsibilities.

Human Resources

.37 The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to:

a. Perform its engagements in accordance with professional standards and regulatory and legal requirements, and

b. Enable the firm to issue reports that are appropriate in the circumstances.

.38 Such policies and procedures should address the following:

- Recruitment and hiring, if applicable;
- Determining capabilities and competencies;
- Assigning personnel to engagements, if applicable;
- Professional development; and

- Performance evaluation, compensation, and advancement.

Recruitment and Hiring

.39 Effective recruitment processes and procedures help the firm select individuals of integrity, who have the capacity to develop the capabilities and competence necessary to perform the firm's work, and possess the appropriate characteristics to enable them to perform competently. Examples of such characteristics may include meeting minimum academic requirements established by the firm, maturity, integrity, and leadership traits.

Determining Capabilities and Competencies

.40 Capabilities and competencies are the knowledge, skills, and abilities that qualify personnel to perform an engagement covered by this section. Capabilities and competencies are not measured by periods of time because such a quantitative measurement may not accurately reflect the kinds of experiences gained by personnel in any given time period. Accordingly, for purposes of this section, a measure of overall competency is qualitative rather than quantitative.

.41 Capabilities and competence are developed through a variety of methods; for example:

- Professional education
- Continuing professional development, including training
- Work experience
- Mentoring by more experienced staff; for example, other members of the engagement team

Competencies of Engagement Partner

.42 A firm's quality control policies and procedures should provide reasonable assurance that an engagement partner possesses the competencies necessary to fulfill his or her engagement responsibilities.

.43 In most cases, an engagement partner will have gained the necessary competencies through relevant and appropriate experience in engagements covered by this section. In some cases, however, an engagement partner may have obtained the necessary competencies through disciplines other than the practice of public accounting, such as in relevant industry, governmental, and academic positions. When necessary, the experience of the engagement partner may be supplemented by continuing professional education (CPE) and consultation. The following are examples.

- An engagement partner whose recent experience has consisted primarily in providing tax services may acquire the competencies necessary in the circumstances to perform a compilation or review engagement by obtaining relevant CPE.
- An engagement partner whose experience consists of performing review and compilation engagements may be able to obtain the necessary competencies to perform an audit by becoming familiar with the industry in which the client operates, obtaining CPE relating to auditing, using consulting sources during the course of performing the audit engagement, or any combination of these.
- A person in academia might obtain the necessary competencies to perform engagements covered by this section by (*a*) obtaining specialized knowledge through teaching or authorship of research projects or similar papers and (*b*) performing a rigorous self-study program, or by engaging a consultant to assist on such engagements.

.44 The characteristics of a particular client, industry, and the kind of service being provided determine the nature and extent of competencies established by a firm that are expected of the engagement partner for an engagement. For example:

- The competencies expected of an engagement partner for an engagement to compile financial statements would be different than those expected of a practitioner engaged to review or audit financial statements.
- Supervising engagements and signing or authorizing others to sign reports for clients in certain industries or engagements, such as financial services, governmental, or employee benefit plan engagements, would require different competencies than those expected in performing attest services for clients in other industries.
- The engagement partner for an attestation engagement to examine management's assertion about the effectiveness of an entity's internal control over financial reporting would be expected to have technical proficiency in understanding and evaluating the effectiveness of controls, while an engagement partner for an attestation engagement to examine investment performance statistics would be expected to have different competencies, including an understanding of the subject matter of the underlying assertion.

.45 In practice, the competency requirements necessary for the engagement partner are broad and varied in both their nature and number. Required competencies include the following, as well as other competencies as necessary in the circumstances.

- *Understanding of the role of a system of quality control and the Code of Professional Conduct*. An understanding of the role of a firm's system of quality control and the AICPA's Code of Professional Conduct, both of which play critical roles in assuring the integrity of the various kinds of reports.
- *Understanding of the service to be performed*. An understanding of the performance, supervision, and reporting aspects of the engagement. This understanding is usually gained through actual participation under appropriate supervision in that type of engagement.
- *Technical proficiency*. An understanding of the applicable professional standards including those standards directly related to the industry in which a client operates and the kinds of transactions in which a client engages.
- *Familiarity with the industry*. An understanding of the industry in which a client operates, to the extent required by professional standards applicable to the kind of service being performed. In performing an audit or review of financial statements, this understanding would include an industry's organization and operating characteristics sufficient to identify areas of high or unusual risk associated with an engagement and to evaluate the reasonableness of industry-specific estimates.
- *Professional judgment*. Skills that indicate sound professional judgment. In performing engagements covered by this section, such skills would typically include the ability to exercise professional skepticism and identify areas requiring special consideration including, for example, the evaluation of the reasonableness of estimates and representations made by management and the determination of the kind of report appropriate in the circumstances.
- *Understanding the organization's information technology systems*. A sufficient understanding of how the organization is dependent on or enabled by information technologies and the manner in which the information systems are used to record and maintain financial information, to determine when involvement of an IT professional is necessary for an audit engagement.

Interrelationship of Competencies and Other Elements of a Firm's System of Quality Control

.46 The competencies listed above are interrelated and gaining one particular competency may be related to achieving another. For example, familiarity with the client's industry interrelates with a practitioner's ability to make professional judgments relating to the client.

.47 In establishing policies and procedures related to the nature of competencies needed by the engagement partner for an engagement, a firm may consider the requirements of policies and procedures established for other elements of quality control. For example, a firm might consider its requirements related to engagement performance in determining the nature of competency requirements that describe the degree of technical proficiency necessary in a given set of circumstances.

The Relationship of the Competency Requirement of the Uniform Accountancy Act to the Human Resource Element of Quality Control

.48 CPAs are required to follow the accountancy laws of the individual licensing jurisdictions in the United States that govern the practice of public accounting. These jurisdictions may have adopted, in whole or in part, the Uniform Accountancy Act (UAA), which is a model legislative statute and related administrative rules designed by the AICPA and the National Association of State Boards of Accountancy (NASBA) to provide a uniform approach to the regulation of the accounting profession. The UAA provides that "any individual licensee who is responsible for supervising attest or compilation services and signs or authorizes someone to sign the accountant's report on the financial statements on behalf of the firm shall meet the competency requirements set out in the professional standards for such services." A firm's compliance with this section is intended to enable a practitioner who performs the services described in the preceding sentence on the firm's behalf to meet the competency requirement referred to in the UAA.

Assignment of Engagement Teams

.49 The firm should assign responsibility for each engagement to an engagement partner and should establish policies and procedures requiring that:

a. The identity and role of the engagement partner are communicated to management and those charged with governance;

b. The engagement partner has the appropriate capabilities, competence, authority, and time to perform the role; and

c. The responsibilities of the engagement partner are clearly defined and communicated to that individual.

.50 Policies and procedures may include systems to monitor the workload and availability of engagement partners so as to enable these individuals to have sufficient time to adequately discharge their responsibilities.

.51 The firm should establish policies and procedures to assign appropriate staff with the necessary capabilities, competence, and time to:

a. Perform engagements in accordance with professional standards and regulatory and legal requirements; and

b. Enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

.52 When assigning engagement teams, and in determining the level of supervision required, the firm might consider factors such as the engagement team's:

- Understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation.
- Understanding of professional standards and regulatory and legal requirements.
- Technical knowledge and expertise, including knowledge of relevant information technology.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- Understanding of the firm's quality control policies and procedures.

Generally, as the ability and experience levels of assigned staff increase, the need for direct supervision decreases.

.53 Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

Professional Development

.54 The continuing competence of the firm's personnel depends to a significant extent on an appropriate level of continuing professional development so that personnel maintain their knowledge and capabilities. Effective policies and procedures emphasize the need for all levels of firm personnel to participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned, and to satisfy applicable continuing professional education requirements of the AICPA and regulatory agencies. Effective policies and procedures also place importance on passing the Uniform CPA Examination. The firm may provide the necessary training resources and assistance to enable personnel to develop and maintain the required capabilities and competence. The firm may use an external source that is qualified for that purpose if internal technical and training resources are unavailable, or for any other reason.

Performance Evaluation, Compensation, and Advancement

.55 The firm's policies and procedures should provide that personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.

.56 Effective performance evaluation, compensation, and advancement procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. Steps a firm may take in developing and maintaining competence and commitment to ethical principles include:

- Making personnel aware of the firm's expectations regarding performance and ethical principles;
- Providing personnel with evaluation of, and counseling on, performance, progress, and career development; and
- Helping personnel understand that their compensation and advancement to positions of greater responsibility depend upon, among other things, performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action.

The size and circumstances of the firm are important considerations in determining the structure of the firm's performance evaluation process. Smaller firms, in particular, may employ less formal methods of evaluating the performance of their personnel.

Engagement Performance

.57 The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are consistently performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances. Required policies and procedures should address:

a. Engagement performance,

b. Supervision responsibilities, and

c. Review responsibilities.

.58 Effective policies and procedures facilitate consistency in the quality of engagement performance. This may be accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry- or subject-matter-specific guidance materials. The firm might address, for example:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work,
- Processes for complying with applicable engagement standards,
- Processes of engagement supervision, staff training, and mentoring,
- Methods of reviewing the work performed, the significant judgments made, and the type of report being issued,
- Appropriate documentation of the work performed and of the timing and extent of the review,
- Appropriate communication of the results of each engagement, and
- Processes to keep all policies and procedures current.

.59 Policies and procedures for engagement supervision might include:

- Tracking the progress of the engagement;
- Considering the capabilities and competence of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions, and whether the work is being carried out in accordance with the planned approach to the engagement;
- Addressing significant issues arising during the engagement, considering their significance, and appropriately modifying the planned approach; and
- Identifying matters for consultation or consideration by more-experienced engagement team members during the engagement.

.60 Review responsibility policies and procedures should be determined on the basis that qualified engagement team members, which may include the engagement partner, review work performed by other team members on a timely basis.

.61 A review may include consideration of whether, for example:

- The work has been performed in accordance with professional standards and regulatory and legal requirements;
- Significant findings and issues have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- The nature, timing, and extent of work performed is appropriate and without need for revision;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the report; and
- The objectives of the engagement procedures have been achieved.

.62 The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis, as appropriate for the nature of the engagement, after the engagement reports have been released. Professional standards, laws, or regulations may prescribe the time limits by which the assembly of final engagement files for specific types of engagements is to be completed.

Confidentiality, Safe Custody, Integrity, Accessibility, and Retrievability of Engagement Documentation

.63 The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.

.64 Relevant ethical requirements establish an obligation for the firm's personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information or there is a legal or professional duty to do so. Specific laws or regulations may impose additional obligations on the firm's personnel to maintain client confidentiality, particularly where data of a personal nature are concerned.

.65 Whether engagement documentation is in paper, electronic, or other media, the integrity, accessibility, and retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the firm's knowledge, or could be permanently lost or damaged. Appropriate and reasonable controls for engagement documentation may include those that:

- Clearly determine when and by whom engagement documentation was prepared or reviewed;
- Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means;
- Prevent unauthorized changes to the engagement documentation; and
- Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

.66 Controls that the firm may design and implement to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation may include, for example:

- The use of a password by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users;
- Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement;
- Procedures for properly distributing engagement documentation to the team members at the start of the engagement, processing it during the engagement, and collating it at the end of the engagement; and
- Procedures for restricting access to and enabling proper distribution and confidential storage of hardcopy engagement documentation.

.67 For practical reasons, original paper documentation may be electronically scanned or otherwise copied to another media for inclusion in engagement files. In that case, the firm should establish procedures designed to maintain the integrity, accessibility, and retrievability of the documentation.

.68 These procedures may include, for example:

- Generating scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;
- Integrating the scanned copies into the engagement files, including indexing and signing off on the copies as necessary; and
- Enabling the scanned copies to be retrieved and printed as necessary.

There may be legal, regulatory, or other reasons to retain original paper documentation.

Retention of Engagement Documentation

.69 The firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm, professional standards, laws, and regulations.

.70 In determining the needs of the firm for retention of engagement documentation and the period of such retention, the firm may consider the nature of the engagement and the firm's circumstances; for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. The retention period may also depend on other factors, such as whether professional standards, laws, or regulations prescribe specific retention periods for certain types of engagements, or whether there are generally accepted retention periods in the absence of specific legal or regulatory requirements.

.71 Procedures that the firm may adopt for retention of engagement documentation include those that:

- Enable the retrieval of and access to the engagement documentation during the retention period, particularly in the case of electronic documentation, as the underlying technology may be upgraded or changed over time.
- Provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed.
- Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

Consultation

.72 The firm should establish policies and procedures designed to provide it with reasonable assurance that:

a. Consultation takes place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues);

b. Sufficient and appropriate resources are available to enable appropriate consultation to take place;

c. All the relevant facts known to the engagement team are provided to those consulted;

d. The nature and scope of such consultations are documented, and are understood by both the individual seeking consultation and the individual consulted; and

e. The conclusions resulting from such consultations are documented and implemented.

.73 Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have relevant specialized expertise.

.74 Consultation uses appropriate research resources as well as the collective experience and technical expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment. Appropriate recognition of consultation in the firm's policies and procedures helps to promote a culture in which consultation is recognized as a strength and encourages personnel to consult on complex, unusual, unfamiliar, difficult, or contentious issues.

.75 The firm's consultation procedures should provide for consultation with those having appropriate knowledge, seniority, and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical, and other matters, and for appropriate documentation and implementation of conclusions resulting from consultations.

.76 A firm needing to consult externally may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control services. Before using such services, the firm should evaluate whether the external provider is qualified for that purpose.

.77 Documentation of consultations with other professionals that involve complex, unusual, unfamiliar, difficult, or contentious matters that is sufficiently complete and detailed contributes to an understanding of:

- The issue on which consultation was sought; and
- The results of the consultation, including any decisions made, the basis for those decisions, and how they were implemented.

Differences of Opinion

.78 The firm should establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted, and, where applicable, between the engagement partner and the engagement quality control reviewer (including a qualified external person). Such policies and procedures should require that:

a. Conclusions reached be documented and implemented; and

b. The report not be released until the matter is resolved.

.79 Effective procedures encourage identification of differences of opinion at an early stage, provide clear guidelines about the successive steps to be taken thereafter, and require documentation regarding the resolution of the differences and the implementation of the conclusions reached. Procedures to resolve such differences may include consulting with another practitioner or firm, or a professional or regulatory body.

Engagement Quality Control Review

.80 The firm should establish criteria against which all engagements covered by this section are to be evaluated to determine whether an engagement quality control review should be performed.

.81 The firm's policies and procedures should require that if an engagement meets the criteria established, an engagement quality control review be performed for that engagement, and that the review be completed before the report is released.

.82 The firm's policies and procedures should require the engagement partner to remain responsible for the engagement and its performance, notwithstanding involvement of the engagement quality control reviewer.

.83 The structure and nature of the firm's practice are important considerations in establishing criteria to consider when determining which engagements are to be subject to an engagement quality control review. Such criteria may include:

- The nature of the engagement, including the extent to which it involves a matter of public interest;
- The identification of unusual circumstances or risks in an engagement or class of engagements; and
- Whether laws or regulations require an engagement quality control review.

.84 If the firm has no engagements that meet the criteria, paragraphs .85–.99 do not apply.

Nature, Timing, and Extent of the Engagement Quality Control Review

.85 The engagement quality control review procedures should include an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report.

.86 The engagement quality control review should include reading the financial statements or other subject matter information and the report and considering whether the report is appropriate.

.87 An engagement quality control review also should include a review of selected engagement documentation relating to the significant judgments the engagement team made and the conclusions they reached, and should include a discussion with the engagement partner regarding significant findings and issues. The extent of the engagement quality control review may depend upon, among other things, the complexity of the engagement and the risk that the report might not be appropriate in the circumstances.

.88 An engagement quality control review may include consideration of the following:

- The engagement team's evaluation of the firm's independence in relation to the specific engagement;
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters and the conclusions arising from those consultations; and
- Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.

.89 Significant judgments made by the engagement team may include, for example:

- Significant risks identified during the engagement and the responses to those risks.
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

.90 The firm's policies and procedures should require the engagement quality control reviewer to conduct the review in a timely manner so that significant issues may be promptly resolved to the reviewer's satisfaction before the report is released. The review may be conducted at appropriate stages during the engagement.

.91 When the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the firm's procedures for dealing with differences of opinion apply (see paragraphs .78–.79).

Criteria for the Eligibility of Engagement Quality Control Reviewers

.92 The firm should establish policies and procedures addressing

a. The appointment of engagement quality control reviewers; and

b. The technical qualifications required to perform the role, including the necessary experience and authority.

.93 The firm's policies and procedures on the technical qualifications of engagement quality control reviewers may address the technical expertise, experience, and authority necessary to fulfill the role. What constitutes sufficient and appropriate technical expertise, experience, and authority depends on the circumstances of the engagement.

.94 The firm should establish policies and procedures designed to maintain the objectivity of the engagement quality control reviewer. Such policies and procedures should provide that while the engagement quality control reviewer is not a member of the engagement team, the engagement quality control reviewer should satisfy the independence requirements relating to the engagements reviewed.

.95 Policies and procedures designed to maintain the objectivity of the engagement quality control reviewer may include a requirement, where practicable, that the engagement quality control reviewer is not selected by the engagement partner, and requirements that the engagement quality control reviewer not:

a. Participate in the performance of the engagement except as discussed in paragraph .96 or

b. Make decisions for the engagement team.

It may not be practicable, in the case of firms with few partners, for the engagement partner not to be involved in selecting the engagement quality control reviewer.

.96 The engagement partner may consult the engagement quality control reviewer at any stage during the engagement, for example, to establish that a judgment made by the engagement partner will be acceptable to the engagement quality control reviewer. Such consultation need not impair the engagement quality control reviewer's eligibility to perform the role. However, when the nature and extent of the consultations become significant, the reviewer's objectivity may be impaired unless both the engagement team and the reviewer are careful to maintain the reviewer's objectivity.

.97 The firm's policies and procedures should provide for the replacement of the engagement quality control reviewer when the reviewer's ability to perform an objective review has been impaired.

.98 Qualified external persons may be contracted when sole practitioners or small firms identify engagements requiring engagement quality control reviews. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. When the firm contracts qualified external persons or other firms, the requirements and guidance in paragraphs .85–.97 apply.

Documentation of the Engagement Quality Control Review

.99 The firm should establish policies and procedures that provide for appropriate documentation of the engagement quality control review, including documentation that:

a. The procedures required by the firm's policies on engagement quality control review have been performed;

b. The engagement quality control review has been completed before the report is released; and

c. The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

Monitoring

.100 The firm should establish policies and procedures designed to provide the firm and its engagement partners with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Such policies and procedures should:

a. Include an ongoing consideration and evaluation of the firm's system of quality control to determine

(i) The appropriateness of the design and

(ii) The effectiveness of the operation of the system of quality control.

b. Assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.

c. Assign performance of monitoring of the firm's system of quality control to qualified individuals.

.101 The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- Adherence to professional standards and regulatory and legal requirements;
- Whether the quality control system has been appropriately designed and effectively implemented; and
- Whether the firm's quality control policies and procedures have been operating effectively, so that reports that are issued by the firm are appropriate in the circumstances.

The evaluation may identify circumstances that necessitate changes to, or the need to improve compliance with, the firm's policies and procedures to provide the firm with reasonable assurance that its system of quality control is effective.

.102 The firm's policies should require the performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and regulatory requirements, and the firm's quality control policies and procedures. Monitoring procedures include:

- Review of selected administrative and personnel records pertaining to the quality control elements.
- Review of engagement working papers, reports, and clients' financial statements.
- Discussions with the firm's personnel.
- Summarization of the findings from the monitoring procedures, at least annually, and consideration of the systemic causes of findings that indicate improvements are needed.
- Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures.
- Communication of the identified findings to appropriate firm management personnel.
- Consideration of findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis.

.103 Monitoring procedures also include an assessment of:

- The appropriateness of the firm's guidance materials and any practice aids;
- New developments in professional standards and regulatory and legal requirements, and how they are reflected in the firm's policies and procedures where appropriate;
- Compliance with policies and procedures on independence;
- The effectiveness of continuing professional development, including training;
- Decisions related to acceptance and continuance of client relationships and specific engagements; and
- Firm personnel's understanding of the firm's quality control policies and procedures, and implementation thereof.

.104 Some of the monitoring procedures discussed above may be accomplished through the performance of:

- Engagement quality control review.
- Postissuance review of engagement working papers, reports, and clients' financial statements for selected engagements.
- Inspection procedures.

.105 The need for and extent of inspection procedures depends in part on the existence and effectiveness of the other monitoring procedures. The nature of inspection procedures varies based on the firm's quality control policies and procedures and the effectiveness and results of other monitoring procedures.

.106 The inspection of a selection of completed engagements may be performed on a cyclical basis. For example, engagements selected for inspection may include at least one engagement for each engagement partner over an inspection cycle that spans three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including the following:

- The size of the firm.
- The number and geographical location of offices.
- The results of previous monitoring procedures.
- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).
- The nature and complexity of the firm's practice and organization.
- The risks associated with the firm's clients and specific engagements.

.107 The inspection process involves the selection of individual engagements, some of which may be selected without prior notification to the engagement team. In determining the scope of the inspections, the firm may take into account the scope or conclusions of a peer review or regulatory inspections. (See paragraph .119.)

.108 Inspection procedures with respect to the engagement performance element of a quality control system are particularly appropriate in a firm with more than a limited number of management-level individuals responsible for the conduct of its accounting and auditing practice.

.109 In small firms with a limited number of persons with sufficient and appropriate experience and authority in the firm, monitoring procedures may need to be performed by some of the same individuals who are responsible for compliance with the firm's quality control policies and procedures. This includes postissuance review of engagement working papers, reports, and clients' financial statements by the person with final responsibility for the engagement. To effectively monitor one's own compliance with the firm's policies and procedures, it is necessary that an individual be able to critically review his or her own performance, assess his or her own strengths and weaknesses, and maintain an attitude of continual improvement. Changes in conditions and in the environment within the firm (such as obtaining clients in an industry not previously serviced or significantly changing the size of the firm) may indicate the need to have quality control policies and procedures monitored by another qualified individual.

.110 Having an individual inspect his or her own compliance with a quality control system may be less effective than having such compliance inspected by another qualified individual. When one individual inspects his or her own compliance, the firm has a higher risk that noncompliance with policies and procedures will not be detected. Accordingly, a firm with a limited number of persons with sufficient and appropriate experience and authority in the firm may find it beneficial to engage a qualified individual from outside the firm to perform inspection procedures.

.111 Any system of quality control has inherent limitations that can reduce its effectiveness. Deficiencies in individual engagements covered by this section do not, in and of themselves, indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards. The firm should evaluate the effect of deficiencies noted as a result of the monitoring process and determine whether they require prompt corrective action.

.112 Deficiencies identified during the monitoring process may be *a.* Instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and regulatory and legal requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances; or

b. Systemic, repetitive or other significant deficiencies that require prompt corrective action.

.113 The firm should communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.

.114 The firm's evaluation of each type of deficiency should result in recommendations for one or more of the following:

a. Taking appropriate remedial action in relation to an individual engagement or member of personnel.

b. The communication of the findings to those responsible for training and professional development.

c. Changes to the quality control policies and procedures.

d. Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.

.115 When the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement, the firm should determine what further action is appropriate to comply with relevant professional standards and regulatory and legal requirements. The firm may also consider obtaining legal advice.

.116 At least annually, the firm should communicate the results of the monitoring of its quality control system process to relevant engagement partners and other appropriate individuals within the firm, including the firm's leadership. Such communication should enable the firm and these individuals to take prompt and appropriate action where necessary in accordance with their defined roles and responsibilities and provide a basis for them to rely on the firm's system of quality control. Information communicated should include the following:

a. A description of the monitoring procedures performed.

b. The conclusions drawn from the monitoring procedures.

c. Where relevant, a description of systemic, repetitive, or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.

.117 The reporting of identified deficiencies to individuals other than the relevant engagement partner need not include an identification of the specific engagements concerned, unless such identification is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partner.

.118 The firm should establish policies and procedures requiring appropriate documentation of monitoring (see paragraph .125). Appropriate documentation relating to monitoring includes:

a. Monitoring procedures, including the procedure for selecting completed engagements to be inspected;

b. A record of the evaluation of:

(i) Adherence to professional standards and regulatory and legal requirements;

(ii) Whether the quality control system has been appropriately designed and effectively implemented; and

(iii) Whether the firm's quality control policies and procedures have been operating effectively, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances; and

c. Identification of the deficiencies noted, an evaluation of their effect, and the basis for determining whether and what further action is necessary.

The Relationship of Peer Review to Monitoring

.119 A peer review does not substitute for all monitoring procedures. However, since the objective of a peer review is similar to that of inspection procedures, a firm's quality control policies and procedures may provide that a peer review conducted under standards established by the AICPA may substitute for the inspection of engagement working papers, reports, and clients' financial statements for some or all engagements for the period covered by the peer review.

Complaints and Allegations

.120 The firm should establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with:

a. Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements; and

b. Allegations of noncompliance with the firm's system of quality control; and

c. Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations.

.121 As part of this process, the firm should establish clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals.

.122 Complaints and allegations of noncompliance with the firm's system of quality control (which do not include those that are clearly frivolous) may originate from within or outside the firm. They may be made by firm personnel, clients, state boards of accountancy, other regulators, or other third parties. They may be received by engagement team members or other firm personnel.

.123 The firm should require that investigations of such complaints and allegations in accordance with established policies and procedures be supervised by a person with sufficient and appropriate experience and authority who is not otherwise involved in the engagement. The firm's policies and procedures may require involving legal counsel in the investigation. Small firms and sole practitioners may use the services of a qualified external person or another firm to carry out the investigation.

.124 The firm should establish policies and procedures requiring documentation of complaints and allegations, and the responses to them.

Documentation of Operation of Quality Control Policies and Procedures

.125 The firm should establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control.

.126 The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including, for example:

- The size of the firm and the number of offices.
- The nature and complexity of the firm's practice and organization.

For example, large firms may use electronic databases to document matters such as independence confirmations, performance evaluations and the results of monitoring inspections. Smaller firms may use more informal methods such as manual notes, checklists, and forms.

.127 The firm should establish policies and procedures that require retention of documentation for a period of time sufficient to permit those performing monitoring procedures and peer review to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

Effective Date

.128 The provisions of this section are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2009.

Appendix B:

Interpretation No. 101-14 of Rule 101

Interpretation No. 101-14 Under Rule 101, *Independence*, "The Effect of Alternative Practice Structures on the Applicability of Independence Rules" (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .16)

Because of changes in the manner in which **members**[*] are structuring their practices, the AICPA's professional ethics executive committee (PEEC) studied various alternatives to "traditional structures" to determine whether additional independence requirements are necessary to ensure the protection of the public interest.

In many "nontraditional structures," a substantial (the nonattest) portion of a member's practice is conducted under public or private ownership, and the attest portion of the practice is conducted through a separate firm owned and controlled by the member. All such structures must comply with applicable laws, regulations, and Rule 505, *Form of Organization and Name* [ET section 505.01]. In complying with laws, regulations, and rule 505 [ET section 505.01], many elements of quality control are required to ensure that the public interest is adequately protected. For example, all services performed by members and persons over whom they have control must comply with standards promulgated by AICPA Council-designated bodies, and, for all other firms providing attest services, enrollment is required in an AICPA-approved practice-monitoring program. Finally, and importantly, the members are responsible, financially and otherwise, for all the attest work performed. Considering the extent of such measures, PEEC believes that the additional independence rules set forth in this interpretation are sufficient to ensure that attest services can be performed with objectivity and, therefore, the additional rules satisfactorily protect the public interest.

Rule 505 [ET section 505.01] and the following independence rules for an alternative practice structure (APS) are intended to be conceptual and applicable to all structures where the "traditional firm" engaged in attest services is closely aligned with another organization, public or private, that performs other professional services. The following paragraph and the chart below provide an example of a structure in use at the time this interpretation was developed. Many of the references in this interpretation are to the example. PEEC intends that the concepts expressed herein be applied, in spirit and in substance, to variations of the example structure as they develop.

The example APS in this interpretation is one where an existing CPA practice ("Oldfirm") is sold by its owners to another (possibly public) entity ("PublicCo"). PublicCo has subsidiaries or divisions such as a bank, insurance company or broker-dealer, and it also has one or more professional service subsidiaries or divisions that offer to clients nonattest professional services (e.g., tax, personal financial planning, and management consulting). The owners and employees of Oldfirm become employees of one of PublicCo's subsidiaries or divisions and may provide those nonattest services. In addition, the owners of Oldfirm form a new CPA firm ("Newfirm") to provide attest services. CPAs, including the former owners of Oldfirm, own a majority of Newfirm (as to vote and financial interests). Attest services are performed by Newfirm and are supervised by its owners. The arrangement between Newfirm and PublicCo (or one of its subsidiaries or divisions) includes the lease of employees, office space and equipment; the performance of back-office functions such as billing and collections; and advertising. Newfirm pays a negotiated amount for these services.

APS Independence Rules for Covered Members

The term **covered member** in an APS includes both employed and leased individuals. The **firm** in such definition would be Newfirm in the example APS. All covered members, including the firm, are subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety. For example, no covered member may have, among other things, a direct financial interest in or a loan to or from an attest client of Newfirm.

[*] Terms shown in **boldface** type upon first usage in this interpretation are defined in ET section 92, *Definitions*.

Partners of one Newfirm generally would not be considered partners of another Newfirm except in situations where those partners perform services for the other Newfirm or where there are significant shared economic interests between partners of more than one Newfirm. If, for example, partners of Newfirm 1 perform services in Newfirm 2, such owners would be considered to be partners of both Newfirms for purposes of applying the independence rules.

APS Independence Rules for Persons and Entities Other Than Covered Members

As stated above, the independence rules normally extend only to those persons and entities included in the definition of covered member. This normally would include only the "traditional firm" (Newfirm in the example APS), those covered members who own or are employed or leased by Newfirm, and entities controlled by one or more of such persons. Because of the close alignment in many APSs between persons and entities included in covered member and other persons and entities, to ensure the protection of the public interest, PEEC believes it appropriate to require restrictions in addition to those required in a traditional firm structure. Those restrictions are divided into two groups:

1. *Direct Superiors.* Direct Superiors are defined to include those persons so closely associated with a partner or manager who is a covered member, that such persons can *directly control* the activities of such partner or manager. For this purpose, a person who can *directly control* is the immediate superior of the partner or manager who has the power to direct the activities of that person so as to be able to directly or indirectly (e.g. through another entity over which the Direct Superior can exercise significant influence[1]) derive a benefit from that person's activities. Examples would be the person who has day-to-day responsibility for the activities of the partner or manager and is in a position to recommend promotions and compensation levels. This group of persons is, in the view of PEEC, so closely aligned through direct reporting relationships with such persons that their interests would seem to be inseparable. *Consequently, persons considered Direct Superiors, and entities within the APS over which such persons can exercise significant influence*[2] *are subject to rule 101 [ET section 101.01*] and its interpretations and rulings in their entirety.

2. *Indirect Superiors and Other PublicCo Entities.* Indirect Superiors are those persons who are one or more levels above persons included in Direct Superior. Generally, this would start with persons in an organization structure to whom Direct Superiors report and go up the line from there. PEEC believes that certain restrictions must be placed on Indirect Superiors, but also believes that such persons are sufficiently removed from partners and managers who are covered persons to permit a somewhat less restrictive standard. Indirect Superiors are not connected with partners and managers who are covered members through direct reporting relationships; there always is a level in between. The PEEC also believes that, for purposes of the following, the definition of Indirect Superior also includes the **immediate family** of the Indirect Superior.

PEEC carefully considered the risk that an Indirect Superior, through a Direct Superior, might attempt to influence the decisions made during the engagement for a Newfirm attest client. PEEC believes that this risk is reduced to a sufficiently low level by prohibiting certain relationships between Indirect Superiors and Newfirm attest clients and by applying a materiality concept with respect to financial relationships. If the financial relationship is not material to the Indirect Superior, PEEC believes that he or she would not be sufficiently financially motivated to attempt such influence particularly with sufficient effort to overcome the presumed integrity, objectivity and strength of character of individuals involved in the engagement.

[1] For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section I82] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

[2] For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section I82] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

Similar standards also are appropriate for Other PublicCo Entities. These entities are defined to include PublicCo and all entities consolidated in the PublicCo financial statements that are not subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

The rules for Indirect Superiors and Other PublicCo Entities are as follows:

A. Indirect Superiors and Other PublicCo Entities may *not* have a relationship contemplated by interpretation 101-1.A [ET section 101.02] (e.g., investments, loans, etc.) with an attest client of Newfirm that is material. In making the test for materiality for financial relationships of an Indirect Superior, all the financial relationships with an attest client held by such person should be aggregated and, to determine materiality, assessed in relation to the person's net worth. In making the materiality test for financial relationships of Other PublicCo Entities, all the financial relationships with an attest client held by such entities should be aggregated and, to determine materiality, assessed in relation to the consolidated financial statements of PublicCo. In addition, any Other PublicCo Entity over which an Indirect Superior has direct responsibility cannot have a financial relationship with an attest client that is material in relation to the Other PublicCo Entity's financial statements.

B. Further, financial relationships of Indirect Superiors or Other PublicCo Entities should not allow such persons or entities to exercise significant influence[3] over the attest client. In making the test for significant influence, financial relationships of all Indirect Superiors and Other PublicCo Entities should be aggregated.

C. Neither Other PublicCo Entities nor any of their employees may be connected with an attest client of Newfirm as a promoter, underwriter, voting trustee, director or officer.

D. Except as noted in C above, Indirect Superiors and Other PublicCo Entities may provide services to an attest client of Newfirm that would impair independence if performed by Newfirm. For example, trustee and asset custodial services in the ordinary course of business by a bank subsidiary of PublicCo would be acceptable as long as the bank was not subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

Other Matters

1. An example, using the chart below, of the application of the concept of Direct and Indirect Superiors would be as follows: The chief executive of the local office of the Professional Services Subsidiary (PSS), where the partners of Newfirm are employed, would be a Direct Superior. The chief executive of PSS itself would be an Indirect Superior, and there may be Indirect Superiors in between such as a regional chief executive of all PSS offices within a geographic area.

2. PEEC has concluded that Newfirm (and its partners and employees) may not perform an **attest engagement** for PublicCo or any of its subsidiaries or divisions.

3. PEEC has concluded that independence would be considered to be impaired with respect to an attest client of Newfirm if such attest client holds an investment in PublicCo that is material to the attest client or allows the attest client to exercise significant influence[4] over PublicCo.

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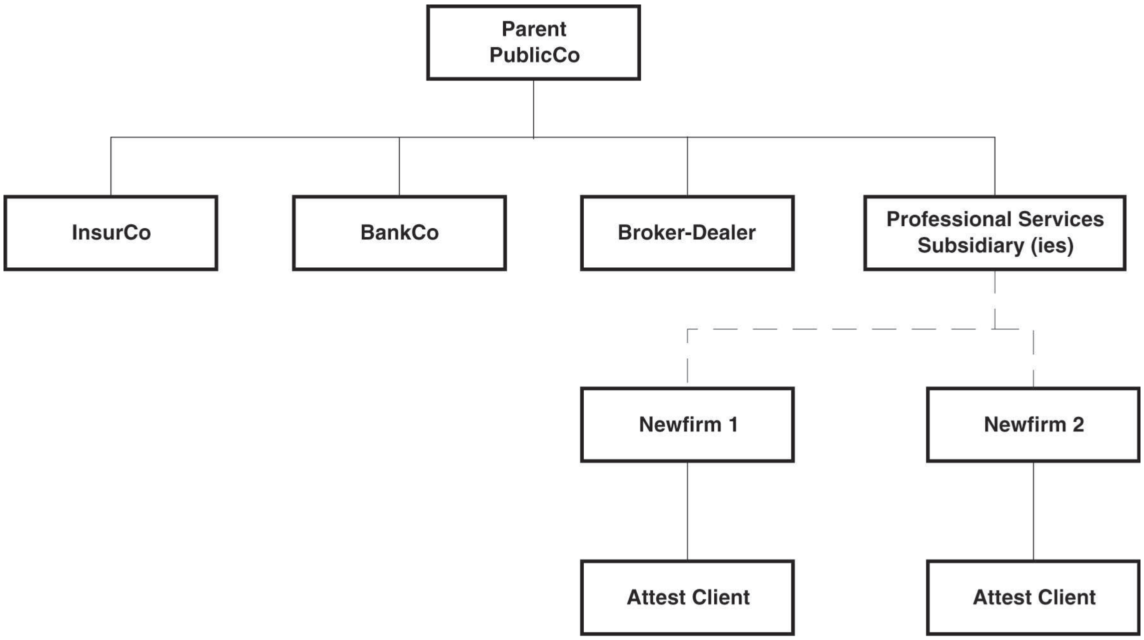
[3] For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section I82] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

[4] For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Accounting Principles Board Opinion No. 18 [AC section I82] and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

4. When making referrals of services between Newfirm and any of the entities within PublicCo, a member should consider the provisions of Interpretation 102-2, *Conflicts of Interest* [ET section 102.03].

Alternative Practice Structure (APS) Model



[*The next page is 10,261.*]

AAM Section 10,250

Statement on Quality Control Standards

Statements on Quality Control Standards (SQCSs) are issued by the Auditing Standards Board. Firms that are enrolled in an AICPA approved practice-monitoring program are obligated to adhere to quality control standards established by the AICPA.

Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control* (QC Section 10)

Supersedes SQCSs Nos. 2–6. SQCS No. 1 was previously superseded by SQCS No. 2.

Effective date: Applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2009.

[*Refer to AAM section 10,200 appendix A for reprint*.]

[*The next page is 10,281.*]

AAM Section 10,280

Interpretation No. 101-14 of Rule 101, Independence

Interpretation No. 101-14 "The Effect of Alternative Practice Structures on the Applicability of Independence Rules" under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .16)

[*Refer to AAM section 10,200 appendix B for reprint*.]

[*The next page is 10,301.*]

AAM Section 10,300

Sample Quality Control Forms

.01 The following are sample documents and forms that practitioners may find useful.

.02 Independence and Representation Checklist for Other Auditors

Office ________________

Firm name ______________

In order to determine that your firm is in compliance with the independence standards, regulations, interpretations and rulings of the AICPA, the [*name of State*] CPA Society, the [*name of State*] Board of Accountancy, and [*name of State*] statutes the following must be completed by _____ [*date*] and returned to _____ as noted. If there are any questions you have related to the completion of the form, or if there is a matter that has come to your attention which may impair your firm's independence, please contact [*name of Partner*] to resolve the problem.

	Yes	***No***
1. We are aware that [*Name of primary auditor*] has been engaged to audit the financial statements of [*Name of parent*] as of [*Date*] and for the [*period, for example, year*] then ended.	_____	_____
2. We are aware that [*Name of primary auditor*] plans to rely on our audit of the financial statements of [*Name of subsidiary or component*] as of [*Date*] and for the [*period, for example, year*] then ended.	_____	_____
3. [We are aware that the primary auditor will refer to our report in their report.]	_____	_____
4. We are independent with respect to [*Name of both the parent and subsidiary or component.*]	_____	_____

______________________________ ______________________________

Partner of other audit firm Date

Reviewed by:

____

Partner of primary audit firm

.03 Scheduling Request

Client ________________________ Engagement No. __________ Year End __________

Partner ________________________ Manager ______________ Tax Ptr/Mgr ________

Personnel Requested	Experience Level	Interim			Year End			Total
		From	Thru	Hours	From	Thru	Hours	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

.04 History of Staff Assignments

NAME ____________________________

				ASSIGNMENT DESCRIPTION				
CLIENT/ LOCATION	DATES INTERIM	DATES YEAR END	RESPONSIBILITY LEVEL	TOTAL HOURS	INDUSTRY	SEC	AUDIT AREAS PERFORMED	REPORTED TO

.05 Client History of Personnel Assigned

CLIENT ______________________________ LOCATION ______________

YEAR ENDING ____________ AUDITED? YES_______ NO _______ SEC? YES_________ NO _________

FISCAL YEAR	HOURS		ENTER NAMES AND CHARGEABLE HOURS FOR THE YEAR							
	INTERIM	YEAR END	PARTNER	MANAGER	SENIOR	IN-CHARGE	STAFF	STAFF	STAFF	STAFF

.06 Scheduling Master Plan

MONTH OF ______

			Nonworking hours								Nonrecurring assignments					Hours for month	
Staff member	Carry forward	Month assign-ments	Vacation	Holiday	Prof dev.	Comp time	CPA exam	Admin	Other	Tax dept	Review dept	Other client #	Other hr	Total assign	Avail-able	(Over) under
Aston	XX	XX	XX	X	X		X					XXXXXX	X	XXX	X	XX
Barry	XX	X	XX	X	X			X	X					XXX	XX	X
Casey	X	X	X	X					X	X				XXX	XX	XX
Davis	XX	X	X	X	X	X	X	X	X	X	X	XXXXXXX	XX	XXXX	XX	(XX)
Evans	X	X	X	X	X	X						XXXXXXX	XX	XXXX		(XX)
Frank	XX	X	X	X	X	X	X	X	X	X	X	XXXXXXX	XX	XXXX	X	(XX)
Louis	XX	X	XX	X	X	X		X		X				XXX	XX	XX
Miceli	XX	X	XX	XX	X	X	X	X						XXX	XX	XX
Total	XXXX	XX	XXX	XXX	XX	XX	XX	XX	XX	XX	XX		XXX	XXX	XXX	XXX

.07 Consultation Log

						MEMORANDUM	
DATE	MODE OF COMMUNICATION	CLIENT	OFFICE	REQUEST	RESPONSE	REQUIRED YES/NO	DATE REC'D
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____
____	____________	______	______	_______	________	________	____

.08 Consultation Worksheet

DATE ____________________

CLIENT NAME ____________________

LOCATION ____________________

ENGAGEMENT (TYPE) ____________________

SUBJECT (QUESTION) ____________________

CONSULTANT'S RESPONSE: (Cite professional literature discussed and conclusion of consultant) ______

FINAL RESOLUTION ____________________

Senior/Manager ____________________ Date ____________________

Partner ____________________ Date ____________________

.09

PRE-EMPLOYMENT APPLICATION

NAME	DATE
ADDRESS	
TELEPHONE NUMBER	SOCIAL SECURITY NUMBER

POSITION APPLIED FOR

FIRST CHOICE	SECOND CHOICE	MINIMUM SALARY REQUIRED: $

☐ Full Time ☐ Permanent Part Time ☐ Temporary ☐ Summer Temporary

REFERRED BY
☐ Newspaper ad ________ (NAME) ☐ Agency ________ (NAME) ☐ Friend ________ (NAME) ☐ Other ________ (NAME)

EDUCATIONAL BACKGROUND — ☐ See Below ☐ See Attached Resume

	NAME & LOCATION OF SCHOOL	MAJOR COURSE	YEARS ATTENDED		YEAR GRAD.
			FROM	TO	
Elementary					
High or Vocational					
Business or Technical					
College					
Graduate					

ADDITIONAL SKILLS OR MACHINE KNOWLEDGE ☐ See Below ☐ See Attached Resume

Note: See the AICPA MAP Handbook for an alternative.

EMPLOYMENT HISTORY — ☐ See Below ☐ See Attached Resume List present (or if currently unemployed, most recent) position first.

FROM	TO	EMPLOYER'S NAME	EMPLOYER'S ADDRESS	POSITION OR TITLE	SUPERVISION	REASON FOR LEAVING

USE THIS SPACE TO ACCOUNT FOR PERIODS NOT WORKED	ADDITIONAL INFORMATION HELPFUL IN CONSIDERING EMPLOYMENT

AGREEMENT

"I certify that the information given by me in this application is true in all respects, and I agree that if employed and it is found to be false in any way, that I may be subject to dismissal without notice, if and when discovered. I authorize the use of any information in this application to enable ________________ to verify my statements, and I authorize ________________, past employers, doctors, all references and any other persons to answer all questions asked by ________________ concerning my ability, character, reputation, and previous employment record. I release all such persons from any liability or damages on account of having furnished such information. I further agree, if employed, that (i) I am to work faithfully and diligently, to be careful and avoid accident, to come to work promptly, and I am not to be absent for any reason without prior notice to my supervisor, (ii) upon termination of employment, ________________ may answer all questions asked of any prospective employer concerning my ability, character, reputation and employment record. I agree to submit to a physical examination whenever requested by ________________ and, if employed, I agree to abide by all present and subsequently issued personnel policies and rules of ____."

APPLICANT'S SIGNATURE: ____ DATE: ________________

.10 Interview Report

DAY ______________

DATE ______________

TIME ______________

NAME OF APPLICANT ____

POSITION APPLIED FOR ____

COMMENTS BY INTERVIEWER:

RECOMMENDED ACTION:

INTERVIEWED BY: ______________________ TITLE: ______________________

PLEASE RETURN TO HUMAN RESOURCES AS SOON AS POSSIBLE

Note: See the AICPA MAP Handbook for an alternative.

.11 Record of Professional Development

Name ______________________ **Employee No.** ______________

Out-of-Office Courses:

	Sponsor	Course description	No. of hours	Date completed
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
9.				
10.				

In-House Programs:

	Instructor	Course description	No. of hours	Date completed
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
9.				
10.				

.12 20XX Professional Development

Summary *(in hours)*

		In-house presentations			
		Developed in-house	Purchased programs	Outside courses	Total
Partners/Owners					
1.					
2.					
3.					

		In-house presentations			
		Developed in-house	Purchased programs	Outside courses	Total
Professional staff					
1.					
2.					
3.					
4.					
5.					
6.					
7.					
8.					
Paraprofessionals					
1.					
2.					
3.					
4.					

.13 20XX Professional Development

Summary *(in dollars)*

	Purchased programs for in-house use	Outside courses	Total
Partners/Owners			
1.	$	$	$
2.			
3.			
Professional staff			
1.			
2.			
3.			
4.			
5.			
6.			
7.			
8.			
Paraprofessionals			
1.			
2.			
3.			
4.			

.14 Performance Evaluation

[To be completed after each engagement of 40 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:	☐	☐	☐	☐	☐

____

____

____

(continued)

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?

Rating: O ☐ VH ☐ G ☐ BN ☐ NA ☐

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?

Rating: O ☐ VH ☐ G ☐ BN ☐ NA ☐

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?

Rating: O ☐ VH ☐ G ☐ BN ☐ NA ☐

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?

Rating: O ☐ VH ☐ G ☐ BN ☐ NA ☐

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?

Rating: O ☐ VH ☐ G ☐ BN ☐ NA ☐

Note: See the AICPA MAP Handbook for alternatives.

Strong points which were evident: ____
____
____
____
____

Recommendations for improvement: ____
____
____
____
____

Comments of Staff Member Being Evaluated: ____
____
____
____
____

Signatures:

Evaluated staff member ______________________________ Date __________

Evaluator ______________________________ Title ______________ Date __________

Engagement manager ______________________________ Date __________

Partner ______________________________ Date __________

.15

JOB EVALUATION REPORT
[For Assignments of Thirty (30) Hours or More]

Name ____

Location ____

Engagement ____

Assistant ______________________ In-Charge ______________________

	Compared to Others in Peer Group							
	A	A-	B+	B	B-	C+	C	
	SUPERIOR	EXCELLENT	ABOVE AVERAGE	SATISFACTORY	IMPROVEMENT DESIRED	IMPROVEMENT REQUIRED	UNSATISFACTORY	NOT APPLICABLE
A. PERFORMANCE ON THE JOB								
1. *Technical Ability Demonstrated*								
a) The purpose of the audit procedures planned was understood								
b) Materiality was neither underestimated nor overestimated								
c) Accounting theory and current releases of the profession were applied correctly								
d) Federal and state income tax regulations were applied correctly								
2. *Working Paper Evidence*								
a) Documentation of work performance, including adequate indexing and cross referencing								
b) Sound explanations and conclusions								
c) Use of standard work papers								
d) Legibility								
e) Accuracy — absence of mathematical errors								
3. *Completing This Job*								
a) Meeting planned time estimates								
b) Completing reports and tax returns								
c) Following up the reviewer's comments and making the necessary changes								
4. *Client Reaction on This Job*								
a) Getting along with the client's employees								
b) Interest in the client's business								
B. ENGAGEMENT ADMINISTRATION — (For In-Charge Accountants Only)								
1. *Effectiveness of Proper Planning*								
a) Extent that the scope of the work related to internal control								
b) Developing the work program								
2. *Utilizing Staff Effectively and Efficiently*								
a) Advance planning to minimize crises								
b) Efficient use of staff on the job								
c) On-the-job training of assistants								
3. *Meeting Deadlines*								
a) Completing the engagement in the planned time								
b) Delivering completed pencil copies of the report and tax returns to the supervisor as agreed								
4. *The Product*								
a) Quality of report preparation, including adequate and informative disclosures								
b) Quality of the management advice recommendations								
5. *Practice Management*								
a) Extending service								
b) Ease of collecting for services performed								

.16

Knowledge and Skill Form

(and Profile of Management Role Performance)

____________________ Staff member evaluated

____________________ Date

____________________ Evaluator

Indicate most effective and least effective roles by placing a check in the far left or right hand column (maximum of two each). For the other five traits, indicate relative strength of staff member by placing a check in columns 2, 3, or 4.

(Circle at least two but not more than four in each section and indicate the effectiveness of each trait.)

			If you wish, add your own words.	Effectiveness Least 1	2	3	4	Most 5
Planner								
Careful	Sloppy	Thorough						
Imaginative	Foresighted	Infrequent						
Routine	Erratic	Last-minute						
Constant	Cautious	Meticulous						
Problem solver								
Analytical	Consistent	Superficial						
Critical	Faulty	Routine						
Hasty	Creative	Reliable						
Slow	Quick	Successful						
Communicator								
Warm	Sloppy	Cold						
Inhibited	Weak	Unstructured						
Thorough	Receptive	Patient						
Expressive	Efficient	Precise						
Leader								
Dominating	Excitable	Partial						
Uncertain	Permissive	Energetic						
Weak	Fair	Heavy-handed						
Loose	Amiable	Sure						
Decision maker								
Decisive	Lone	Delayer						
Slow	Avoider	Reliable						
Quick	Seldom	Participative						
Frequent	Rash	Dependent						
Trainer								
Systematic	Unprepared	Conscientious						
Patient	Efficient	Knowledgeable						
Sloppy	Diligent	Disinterested						
Off-on	Slow	Enthusiastic						
Team member								
Cooperative	Unreliable	Independent						
Influential	Divisive	Undisciplined						
Conformist	Reliable	Contributing						
Forceful	Reluctant	Welcome						
Innovator								
Original	Appropriate	Consistent						
Infrequent	Clever	Sensible						
Unnecessary	Creative	Unimaginative						
Constant	Disruptive	Rash						
Job expertise								
Amateur	Improving	Too technical						
Obsolete	Mediocre	Disinterested						
Masterful	Balanced	Lagging						
Versatile	Up-to-date	Thorough						

(Complete Annually)

.17 Employee Annual Performance Appraisal

Time Period Involved			
From	To		☐ EXEMPT ☐ NON-EXEMPT

Name		Position Title	Number
Hire Date	Present Position Date	Days Absent From: ____________ To: ______ Charged To Sick Time: ______________ Disability: ______________	

Strengths	Development Needs
	Suggested Plan for Performance Improvement

Summary

Overall Rating on Having Met Job Requirements	
Non-Exempt - Circle One	Exempt - Circle One
1 2 3	1 2 3 4 5
1 = Did Not Meet Job Requirements 2 = Met All 3 = Exceeded	1 = Did Not Meet Job Requirements 2 = Met Most 3 = Met All 4 = Exceeded 5 = Far Exceeded

Review the following questions before answering them, using the following criteria:

- A *yes* answer should be considered for possible mention as a "strength." If so, refer to it on the first page of this evaluation.
- A *no* answer should be considered for possible mention as a "development need." If so, refer to it on the first page of this evaluation.

All answers should be considered in arriving at an overall rating on having met job requirements.

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
Quality of Work					
Is work accurate, neat, and clearly presented?	( )	( )	( )	( )	( )
Carefully planned, well organized, and thorough?	( )	( )	( )	( )	( )
Productivity					
Is a good level of production maintained?	( )	( )	( )	( )	( )
Are deadlines met?	( )	( )	( )	( )	( )
Are pressure situations handled effectively?	( )	( )	( )	( )	( )
Knowledge of Job					
Does the individual know where to get information?	( )	( )	( )	( )	( )
Is the individual used as a source of information by others?	( )	( )	( )	( )	( )
Communication					
Does the individual ask for clarification when necessary?	( )	( )	( )	( )	( )
Does the individual respond to others in a manner that indicates understanding?	( )	( )	( )	( )	( )
Are ideas expressed so that others are able to understand them?	( )	( )	( )	( )	( )
Human Relations					
Does the individual cooperate with others to get the job done?	( )	( )	( )	( )	( )
Does the individual demonstrate tact and courtesy in dealing with others?	( )	( )	( )	( )	( )
Does the individual maintain a good working relationship with all others?	( )	( )	( )	( )	( )
Are questions and requests dealt with in a helpful manner?	( )	( )	( )	( )	( )
Need for Supervision					
Can the individual be relied upon to get work done without close supervision?	( )	( )	( )	( )	( )
Does the individual take the initiative when appropriate?	( )	( )	( )	( )	( )
Problem Solving					
Does the individual collect the data needed to solve problems?	( )	( )	( )	( )	( )
Are problems solved quickly?	( )	( )	( )	( )	( )

(continued)

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
Problem Solving—cont'd					
Are solutions reasonable and accurate?	( )	( )	( )	( )	( )
Does the individual know when to ask for advice and whom to ask?	( )	( )	( )	( )	( )
Does the individual seek out methods to do work more efficiently?	( )	( )	( )	( )	( )
Are alternate solutions generated when appropriate?	( )	( )	( )	( )	( )
Work Habits					
Does the individual comply with the AICPA's established work hours?	( )	( )	( )	( )	( )
Does the individual provide proper notification when absent from work?	( )	( )	( )	( )	( )
Personal Development					
Does the individual try to expand on required knowledge and skills?	( )	( )	( )	( )	( )
Does the individual readily grasp and master the new job requirements?	( )	( )	( )	( )	( )
Does the individual show ambition by building on strengths and working on deficiencies?	( )	( )	( )	( )	( )
Is the individual a good candidate for promotion?	( )	( )	( )	( )	( )
Is the individual ready for promotion at this time?	( )	( )	( )	( )	( )
Supervisory Capabilities					
Does the individual demonstrate the ability to direct and be responsible for the performance of others?	( )	( )	( )	( )	( )
Does the individual effectively evaluate and develop subordinates?	( )	( )	( )	( )	( )
Are subordinates properly motivated?	( )	( )	( )	( )	( )
Are subordinates given reasonable goals and aided in meeting them?	( )	( )	( )	( )	( )
Does the individual comply with administrative and policy guidelines of _________?	( )	( )	( )	( )	( )
Is good judgment exercised in observing budget constraints?	( )	( )	( )	( )	( )
Does the individual maintain adequate discipline in regard to subordinates attendance and punctuality?	( )	( )	( )	( )	( )
Does the individual provide a good example for peers and subordinates to follow?	( )	( )	( )	( )	( )

INCUMBENT REVIEW COMMENTS & ACKNOWLEDGEMENT
I acknowledge that: (1) I have reviewed and discussed this performance appraisal with the preparer. My signature means that I have been advised of my performance evaluation but does not necessarily imply that I agree with it; (2) I have received a copy of the goals/duties that will be used to evaluate my performance during the coming year; and (3) I have reviewed my job description and do ☐ do not ☐ feel it should be revised. My signature and the date I discussed this with the preparer appears below.

Employee	Date
Evaluator/Title	**Date**

.18 Client/Engagement Acceptance and Continuation Checklist [1]

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?) ______________________________
____
____

[1] 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?____
____
____

.19

Summary Control Checklist

Firm Name ______________________
Quality Control Monitoring System Summary

Year Ended ______________________

Monitoring Procedure	Reviewed By	Reviewed Date	Location of Documentation
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.			

.20 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[2]				
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 (AICPA, *Professional Standards*, vol. 1, AU sec. 561)? Yes ________ No ________

2. Performing additional auditing procedures to provide a satisfactory basis for a previously expressed opinion, pursuant to SAS No. 46 (AICPA, *Professional Standards*, vol. 1, AU sec. 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 ____________________

[2] 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.

		Reviewed		**Relevant?**		
Professional Pronouncement	**Effective Date**	**By**	**Date**	**Yes**	**No**	**Comment, Reference**
Auditing Standards Statement on Auditing Standards No. 94, *The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*	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, *Accounting and Reporting by Health and Welfare Benefit Plans*	Financial statements for plan years beginning after 12/15/00					
Other Professional Pronouncements Office of Management and Budget Circular A-133, *Audits of Institutions of Higher Education and Other Non-Profit Institutions*	Years ending on or after 6/30/97					

		Reviewed		Relevant?		
Professional Pronouncement	**Effective Date**	**By**	**Date**	**Yes**	**No**	**Comment, Reference**
Financial Accounting Standards Board Statement No. 139, *Rescission of FASB Statement No. 53 and amendments to FASB Statements No. 63, 89, and 121*	Years beginning after 12/15/00					
Governmental Accounting Standards Board						
Other Pronouncements						

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AAM TOPICAL INDEX

References are to section and paragraph numbers.

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